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Politics this week

Mar 22nd 2007
From The Economist print edition

AFP

The mayhem continued in **Iraq**. Among the atrocities were three car-bombs (two near Fallujah, the third near Ramadi) that used chlorine gas. These attacks killed eight people and injured more than 350. Meanwhile, anti-war protests in America and elsewhere marked the fourth anniversary of the invasion.

A new Hamas-Fatah unity government took control of the **Palestinian Authority**. But Hamas's refusal to renounce violence against Israel means an international boycott remains in place. See article

Russia was reported to have withdrawn assistance from the nuclear reactor it is building in **Iran** at Bushehr. It was not clear whether this was because of a commercial spat or part of the international campaign to stop Iran from enriching uranium.

There was heavy fighting in the **Somali** capital, Mogadishu, after government and Ethiopian troops tried to enter an Islamist insurgent stronghold. The corpses of two soldiers were dragged through the streets. There has been a rise in attacks by the remnants of the Islamist militias, which were defeated by Ethiopian-backed forces in December. See article

As a government crackdown on opposition leaders continued in **Zimbabwe**, some of its neighbours were, for the first time, openly critical of President Robert Mugabe. With thousands fleeing the country Levy Mwanawasa, Zambia's president, compared Zimbabwe to the “sinking *Titanic*”. See article

So much for bipartisanship

The row over last year's sacking of eight **federal prosecutors** gathered steam. A committee in Congress authorised subpoenas in order to get White House aides to testify on Capitol Hill. George Bush said he would not allow them to do so on the ground that it would be a “witch hunt”.

Kathleen Blanco decided not to seek re-election as **Louisiana's** governor later this year. Ms Blanco, a Democrat, had seen her political stock tumble in the state with the failure of her “Road Home” rebuilding programme in the aftermath of Hurricane Katrina.

Presidential candidates started to rethink their campaign strategies after California moved forward the date of its **primary** to February 5th 2008. Legislators in New York also approved a measure to move its primary to that date. New Hampshire, which holds the first primary, has not ruled out bringing its election forward to as early as December.

Show the cash and we'll talk

EPA

Six-party talks in Beijing aimed at persuading **North Korea** to abandon its nuclear programme ended in disarray. The North Korean delegation went home early angry that $25m, frozen in a bank in Macau, had not yet reached its account. On the eve of the talks, America had agreed to the transfer of the money. See article

The confrontation between **Pakistan's** president, General Pervez Musharraf, and the country's judiciary worsened. Eight judges have resigned in protest at General Musharraf's attempt to dismiss Iftikhar Chaudhry, the chief justice, on

charges of misconduct and misuse of authority. Opposition parties have rallied to Mr Chaudhry's defence.

More than 100 people were reported killed in Pakistan's tribal area of **South Waziristan** in days of fighting between local ethnic-Pushtun tribesmen and foreign militants. The Afghan government says the area provides sanctuary for Taliban fighters waging an insurgency against it and its NATO allies.

An Italian journalist was freed from captivity in **Afghanistan** in exchange for five Taliban fighters. America made a formal diplomatic complaint to Italy about the deal.

Heavy fighting erupted in eastern **Sri Lanka** between government troops and rebels from the Liberation Tigers of Tamil Eelam. The Tigers attacked four army bases from land and sea. Neither side has repudiated the 2002 ceasefire agreement, but the country is sliding ever closer to all-out civil war.

In **Thailand**, the police recommended that Thaksin Shinawatra, the exiled former prime minister ousted in a coup last September, be charged on three counts of insulting the country's much-revered king.

Eyes on the prize

Twelve candidates got on the ballot for the first round of **France's** presidential election on April 22nd. The centre-right front-runner, Nicolas Sarkozy, widened his opinion-poll lead a little and won an endorsement from President Jacques Chirac. The centrist François Bayrou is still snapping at the heels of the Socialist candidate, Ségolène Royal. See article

Finland's election confirmed a shift to the right in the Nordic region. The ruling Centre Party of Matti Vanhanen won the most seats, but he may have to link with the conservative National Coalition Party instead of his current partner, the Social Democrats, who slumped to their worst result since 1962.

Gordon Brown, who is likely to take over from Tony Blair as prime minister, unveiled his final budget as **Britain's** chancellor. It included a flamboyant 2p cut in the main rates of income and corporation tax. See article

Two submariners from *HMS Tireless*, a British navy **nuclear-powered submarine**, died when an air filter exploded on board. The boat, which was patrolling off Alaska, has run into trouble before. In 2000 she had to make a lengthy stop in Gibraltar, causing a diplomatic row with Spain.

Caught in the middle

Colombia's government said it would consider seeking the extradition of senior managers of Chiquita Brands, a banana company, after it pleaded guilty in an American court to charges that its former subsidiary in the country paid $1.7m to right-wing paramilitaries in order to protect its workers. The company said it also paid left-wing guerrillas.

In a bad week for the illegal drug industry, Panamanian police, working with agents from the United States Drug Enforcement Administration, seized almost 20 tonnes of cocaine from a ship off the Pacific coast, while Mexican police found $206m in cash in a Mexico City house used by a methamphetamine syndicate.

AFP

Rafael Correa, **Ecuador's** new left-wing president, appeared to win his battle with the formerly opposition-dominated Congress. The electoral tribunal, having expelled 57 legislators, swore in 21 of their alternates who support Mr Correa. Provided with a pro-government quorum, Congress met under police guard.

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Business this week

Mar 22nd 2007
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Barclays confirmed it was talking to **ABN Amro** about a merger. A combination of the British and Dutch banks would create one of the world's biggest financial institutions with interests in retail and investment banking. As negotiations continued, other European banks were rumoured to be interested in buying all (or part) of ABN AMRO, which is resisting a call for its break-up from an activist hedge fund. See article

Wal-Mart withdrew its application to enter the banking business, saying it had been surrounded by "manufactured controversy". The retailer had been opposed by consumer groups and community banks, though Wal-Mart had insisted its intention had been to cut its own transaction costs, not to start a retail bank.

Morgan Stanley won its appeal against the $1.6 billion in damages awarded to Ronald Perelman in 2005. The billionaire investor alleged he had received fraudulent advice from the bank about the finances of Sunbeam, a maker of household appliances that eventually went bankrupt. A state appeals court in Florida ruled he did not prove the level of damage at the original trial.

In harm's way

BP was berated for having a weak safety culture in the final report from America's Chemical Safety Board into the blast at a Texas refinery in March 2005 that killed 15 workers and injured scores of others. The inquiry concluded that the oil company paid more attention to cutting costs at the facility than to the threat of an explosion. BP is being investigated by the Justice Department and faces the possibility of criminal charges. See article

Rosneft, Russia's state oil company, disclosed it had secured $22 billion in loans from a consortium of Western banks so that it could bid at auction for refineries once owned by **Yukos**, a private oil firm that was forced to sell its main assets by the Russian government and was thereby bankrupted. It is one of the largest loans given to a Russian company.

In a deal worth $4 billion—one of the biggest in Brazil—**Petrobras**, the state-run oil company, and two partners announced a plan to buy **Ipiranga**, a fuel distributor and refiner. The decision follows the government's recent stated intention to expand its strategic role in the energy sector.

Returns policy

John Antioco quit **Blockbuster** as chief executive after months of criticism from shareholders (led by Carl Icahn) about the size of his pay given the company's languid performance. Mr Antioco has now agreed to take much smaller sums in both bonus and severance pay when he leaves at the end of this year.

Investors were excited at reports that **Blackstone**, which has funded some of the biggest buy-outs over the past two years, might offer some shares to the public. As well as pondering what such a decision might mean for future buy-outs, analysts were eager to learn what the private-equity firm's prospectus could reveal about its operations. See article

The founder of **Affiliated Computer Services** unveiled an $8.2 billion buy-out offer for the computer-outsourcing company backed by **Cerberus Capital Management**, a private-equity firm. The chief executive and chief financial officer of ACS resigned last year amid an internal inquiry into its stock-option practices.

Community Health Systems agreed to buy **Triad Hospitals**, a rival, pipping a buy-out offer that had been made by two private-equity firms. The $6.8 billion deal creates the biggest publicly traded hospital

operator in America (HCA went private in a management-led buy-out last year) with 144 medical facilities, primarily in the south.

Airbus's A380 made inaugural flights to the United States in order to test the runway upgrades of airports that are trying to accommodate the world's biggest passenger jet, which has faced a series of embarrassing production delays and losses. The aircraft touched down in New York and Los Angeles ahead of schedule.

The Federal Reserve held its main **interest rate** steady at 5.25%, but the tone of its accompanying statement was interpreted by the markets to mean the central bank was becoming flexible towards the idea of future rate-cuts.

Cause for concern?

Infographics

The Fed meeting came after the release of new **inflation** figures. America's headline consumer prices increased by 0.4% in February compared with January as fuel and medical-care costs rose sharply (the core inflation rate, which excludes energy and food, slowed). There was also a rise in **Britain's** consumer-price index, but more attention was paid to its retail-price index, which includes mortgage payments. Thus measured, annual inflation jumped to 4.6%.

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KAL's cartoon

Mar 22nd 2007
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Kevin Kallaugher

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Housing markets

The trouble with the housing market

Mar 22nd 2007
From The Economist print edition

After the great global housing binge, the hangover is kicking in. Especially in America

James Fryer

JUNE is National Homeownership Month in America. National Foreclosure Month would be more apt. Some corners of the mortgage market—notably “subprime” loans aimed at those with poor credit records—have a nasty case of dry rot. One subprime borrower in eight is behind with the payments. As the introductory “teaser” rates on more loans expire and monthly payments outrun the means of more borrowers, hundreds of thousands of Americans are set to be thrown onto the street.

Only a few weeks ago you could find voices claiming that the worst was over for America's sagging housing market. That is harder now. Although it is too soon to be truly gloomy about the broader economy, any structural surveyor would spot tightening credit and a glut of housing supply. The foundations are not much better: falling house prices are no good for consumer spending, which has been propping the economy up (see article).

Other countries may also be looking nervously at America. And about time. An American recession would scarcely be welcome—even if for the moment Asian and European economies seem to be doing nicely on their own account. However, the true cause for concern is that just as America's housing boom was part of a synchronised global binge on cheap money, its bust may be part of a global story too.

After a long, long night on the tiles

Listen around the world and you can hear echoes of America's difficulties—even if prices have not yet started to tumble. Start with subprime borrowers. In America these people are, not surprisingly, poorer (and less likely to be white) than those who can obtain mortgages at lower, usually fixed rates. They tended to join the great housing-market party late, when prices were already sky-high. Many appear to have been encouraged to take out loans by brokers more bothered about their fees than their clients' ability to repay their debts. And the lenders who advanced the money—dozens of which have had to shut up shop—underestimated the rate of default. Generously, you could ascribe this to the relative youth of the subprime market. Less generously, you might point to the effect of “securitisation” on lenders' incentives: knowing that loans could be lumped together and sold, and then chopped, repackaged and sold again, made for slack judgment.

To Britons, much of this will sound alarmingly familiar. “Self-certification” mortgages (translation for

Americans: “undocumented” or “liar” loans) and interest-only loans have become more common as borrowers, especially young ones hoping to buy their first home or neophyte landlords who think that a string of properties will be their pensions, stretch their budgets (see article). In Spain lenders are courting the country's army of young immigrants, who often have short or patchy credit histories—and often, it seems, work on building sites themselves.

The other American theme is that homebuyers and lenders are reaping the consequences of loose monetary policy. When the Federal Reserve cut interest rates after the tech bubble burst, it inflated another, in housing. In Europe you can see a similar story. The single currency has brought the euro area's star performers, Spain and Ireland, unsuitably low interest rates—and house-price increases of 180% and 250% respectively in the past decade. Now both look too dependent on housing. In Spain, where the rate of house-price inflation has eased—eased—to 9% or so, housing investment now accounts for 7.5% of GDP. Were this ratio to fall to, say, 6%, still above the average for the rest of the euro area, job losses in building could cut employment growth by a percentage point a year.

Ireland looks rockier still. Housebuilding accounts directly for a staggering 15% of national income and 12% of employment. Whereas prices have soared, rents have stagnated in recent years and, at 4%, rental yields in Dublin do not cover even the cost of borrowing. Now prices are flattening too. According to Morgan Kelly, of University College, Dublin, to return the ratio of prices to rents to where it was around 2000, real prices will need to fall by 40-60% in the next eight or nine years.

What next?

Americans and others may be tempted to take heart from apparent soft landings in Britain and Australia. That would be a mistake. Admittedly Britain's housing market has had a second wind since a surprise interest-rate cut in 2005. But the effects of rate increases since may not have come through yet. And Australian prices have undergone huge regional variations. Buy-to-let investors in Sydney flats, who saw prices drop, may think their landing rather bumpy.

Inevitably, Americans will ask what policymakers can do. It is too late to unwind monetary policy of a few years ago; cutting rates now risks compounding the error. The Fed's main worry is inflation—and rightly so. Given the slackness of lending standards, especially in the subprime market, there is an argument for tighter oversight of non-bank mortgage companies, and at the federal rather than state level. It is tempting to blame securitisation for much of the mess. But the technique has been a boon, by and large, making credit markets of all sorts more liquid. And despite the arrears and foreclosures, subprime lending has been part of what Alan Greenspan once called a democratisation of credit. More Americans are able to borrow and buy houses. Most manage.

The economic consequences may yet be large; so may the political ones. Most of the gains from America's recent economic success have been scooped by those at the top of the pile—not least in the financial industry. Now many lower down face unpayable debts and the loss of their homes.

Populist politicians may well make much of the contrast between a second house in the Hamptons and no house at all. Instead, they should stop making a fetish of homeownership. That people are free to borrow to buy their own home, should they wish, is fine. That politicians should encourage homeownership for its own sake is not. That they foster it with tax breaks, as they do in America, is daft.

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Human rights

Stand up for your rights

Mar 22nd 2007
From The Economist print edition

The old stuffy ones, that is: newer ones are distractions

Claudio Munoz

THE past few years have been busy ones for human-rights organisations. In prosecuting the so-called war on terror, many governments in Western countries where freedoms seemed secure have been tempted to nibble away at them. Just as well, you might suppose, that doughty campaigners such as Amnesty International exist to leap to the defence. Yet Amnesty no longer makes the splash it used to in the rich world (see article). This is not for want of speaking out. The organisation is as vocal as it ever was. But some years ago it decided to follow intellectual fashion and dilute a traditional focus on political rights by mixing in a new category of what people now call social and economic rights.

Rights being good things, you might suppose that the more of them you campaign for the better. Why not add pressing social and economic concerns to stuffy old political rights such as free speech, free elections and due process of law? What use is a vote if you are starving? Are not access to jobs, housing, health care and food basic rights too? No: few rights are truly universal, and letting them multiply weakens them.

Food, jobs and housing are certainly necessities. But no useful purpose is served by calling them “rights”. When a government locks someone up without a fair trial, the victim, perpetrator and remedy are pretty clear. This clarity seldom applies to social and economic “rights”. It is hard enough to determine whether such a right has been infringed, let alone who should provide a remedy, or how. Who should be educated in which subjects for how long at what cost in taxpayers' money is a political question best settled at the ballot box. So is how much to spend on what kind of health care. And no economic system known to man guarantees a proper job for everyone all the time: even the Soviet Union's much-boasted full employment was based on the principle “they pretend to pay us and we pretend to work”.

It is hardly an accident that the countries keenest to use the language of social and economic rights tend to be those that show least respect for rights of the traditional sort. The rulers of Cuba and China habitually depict campaigns concentrating on individual freedoms as a conspiracy by the rich northern hemisphere to do down poor countries. It is mightily convenient, if you deprive your citizens of political liberties, to portray these as a bourgeois luxury.

And it could not be further from the truth. For people in the poor world, as for people everywhere, the most reliable method yet invented to ensure that governments provide people with social and economic necessities is called politics. That is why the rights that make open politics possible—free speech, due process, protection from arbitrary punishment—are so precious. Insisting on their enforcement is worth

more than any number of grandiloquent but unenforceable declarations demanding jobs, education and housing for all.

Many do-gooding outfits suffer from having too broad a focus and too narrow a base. Amnesty used to be the other way round, appealing to people of all political persuasions and none, and concentrating on a hard core of well-defined basic liberties. No longer. By trying in recent years to borrow moral authority from the campaigns and leaders of the past and lend it to the woollier cause of social reform, Amnesty has succeeded only in muffling what was once its central message, at the very moment when governments in the West need to hear it again.

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America and Colombia

How to boost the coca crop

Mar 22nd 2007
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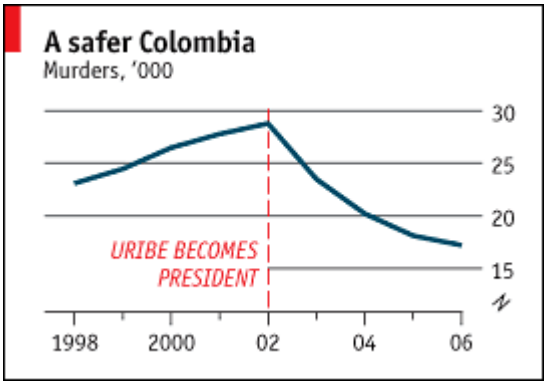
If the Democrats turn against Colombia's president, they will damage American interests



THE United States, it is said with some justification, has neglected Latin America. But there is one big exception: Colombia. Since 1999, first under Bill Clinton and then under George Bush, it has given some $4.5 billion under the guise of Plan Colombia, a scheme to fight drug trafficking and guerrillas. That amounts to the biggest aid commitment outside the Middle East and Afghanistan. It has been possible because both parties supported the idea of backing Colombia's embattled democracy. But that consensus may now be crumbling—just when the policy seems to be working fairly well.

There are two reasons why the Democrats now in control of Congress have become increasingly queasy. The biggest one is Colombia's combative president, Álvaro Uribe. Recent revelations have linked several of his supporters and a former senior official to right-wing paramilitary militias. The country's Supreme Court has ordered the arrest of nine legislators who support Mr Uribe and who are accused of such links. Most shocking is the case of Jorge Noguera, whom Mr Uribe appointed as head of the state intelligence service. He is accused of having collaborated with the paramilitaries, to the extent of providing lists of trade unionists who were later murdered because of their alleged links to left-wing guerrillas. These revelations come as a controversial peace process under which some 30,000 paramilitaries gave up their weapons risks unravelling. Several thousand of the militiamen, it is feared, have returned to arms and to crime.

For Mr Uribe's opponents, these troubling stories are proof that the president is in league with the paramilitaries. He certainly has faults, one of which is his sometimes poor choice of collaborators. But his vigorous opposition to the left-wing guerrillas who have plagued his country is combined with a commitment to a democratic system he has done much to strengthen (see article). He has, for instance, given full backing to the judicial investigations into paramilitary infiltration of the state.

If Mr Uribe keeps bad company, it is the result of an instinctive reluctance to leave any political space to his right. Yet it is this tactic that has enabled him to convince the paramilitaries to disarm and face justice. Their demobilisation has been full of improvisation and imperfections. But the process has acquired a momentum of its own that offers a path towards peace and the strengthening of the rule of law. Putting the paramilitary leaders on trial, combating any of their followers who return to violence and helping the rest to adopt civilian lives would be complicated in a far more developed country. In Colombia, it is conceivable only in the climate of greater security that Mr Uribe has created.

Stop spraying coca but don't stint on security

The Democrats' second criticism is that Plan Colombia focuses too much on military aid and drug-fighting and too little on development. There's something in that. But Colombia is still under assault from the guerrillas and other drug traffickers. It is naive to think that human rights can be protected and the countryside developed in an atmosphere of violence.

Lasting security, admittedly, cannot be achieved by military means alone. Still less can the country be made safe and prosperous by the policy of spraying weedkiller on coca crops—a futile exercise that has failed to staunch the flow of cocaine to the United States and has alienated large numbers of peasants. So Mr Uribe should combine his emphasis on security with other policies, such as rural development and

strengthening the rule of law. Indeed, his government should risk being even more radical. Colombia is in urgent need of land reform and now has an unparalleled opportunity to introduce it: hundreds of thousands of people displaced by rural violence could be settled on land confiscated from paramilitaries and drug traffickers.

The Democrats who are fed up with Mr Uribe are thinking of blocking a pending free-trade agreement with Colombia. They do not much like free trade anyway (which is why they may also block an agreement with Peru). But although they may find protectionist arguments seductive, they should look to their country's wider interests. Blocking these deals would send a powerful message to Latin Americans to give up on the United States and trust instead in the bountiful aid offered by Venezuela's oil-rich demagogue, Hugo Chávez. And hampering the free movement of goods would discourage Colombian farmers from diversifying away from coca and into legal crops. Cocaine, after all, does not face tariffs.

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The Middle East

Time for an Arab road map

Mar 22nd 2007
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Israel's neighbours should seize the initiative to resolve the conflict with Palestinians

AP

PALESTINIANS have been on the brink of civil war ever since Hamas swept the old Fatah elite from power last year. With a unity government sworn in on March 17th, they may have made peace among themselves. But does this welcome development bring them any closer to making peace with Israel?

The new cabinet is led by the same prime minister from Hamas, Ismail Haniyeh, whose first government was ostracised by Israel and the world because it rejected three demands: renounce violence, recognise Israel and honour previous Palestinian agreements. This time members of Fatah, small centrist parties and independents have been given key ministries. But of the three tests, the government has agreed, in a roundabout way, only to “respect” earlier accords. Indeed, Mr Haniyeh declared that Palestinians were entitled to wage “resistance in all its forms” against Israel (see article).

Peace comes in half-steps

Does the creation of this government mark a moderate step by Hamas or a surrender by Fatah? Many Palestinians say Hamas is being more pragmatic: though it will not accept the three demands now, it might do so in the context of a credible peace. Israel disagrees, accusing Fatah of signing up to an extremist agenda. Israel is therefore refusing to recognise the new government or release its funds. And it has downgraded contacts with Fatah's Mahmoud Abbas, the Palestinian president.

Though Israel's exasperation is understandable, it would be wiser to take a half-step in response to what some see as a half-step by Hamas. It could for example give back some money for humanitarian needs and maintain contact with the moderates it has always talked to. America and Europe are already moving this way, and Israel risks isolating itself.

The Arab states have a role to play as well. At a summit in Riyadh next week their leaders intend to relaunch the peace initiative they signed in Beirut in 2002. This offered Israel peace and normal relations in return for a full withdrawal from the territories it occupied in 1967. But the initiative was stillborn, not least because it coincided with the Palestinian *intifada* and one especially terrible atrocity in which a Hamas suicide-bomber blew himself up in a hotel, killing 30 Israelis at Passover. Arab leaders did not utter a word of condemnation. The response of Ariel Sharon, then prime minister, was to send his army

back into the cities of the West Bank, from which it had withdrawn under the Oslo peace accords.

The Arabs are right to try again. But this time they need to go beyond the simple declaration of a take-it-or-leave-it final deal. They should draw up their own “road map” to peace.

An international road map has of course existed for four years. This envisaged three steps. First would come an end to terrorism and a freeze on Jewish settlement in the occupied territories. The Palestinians would then get a provisional state with temporary borders. Only later would there be negotiation on a permanent peace. This map's defect was that it detailed the first steps but was vague about the destination. Without knowing that, neither side was eager to start the journey. The Beirut initiative suffers from the opposite weakness. It specifies a destination that no Israeli government could accept, since it entails Israel giving up every inch of land occupied in 1967 and implies letting all refugees displaced by the creation of the Jewish state return to what is now Israel.

In fact, as serious peacemakers on both sides know, any mutually acceptable peace would have to resemble Bill Clinton's “parameters” of 2000: Israel's withdrawal from most but not all of the West Bank, land swaps to make up for any chunks it keeps, a deal to share Jerusalem and the return of most refugees to a Palestinian state rather than Israel proper.

A good way to restart diplomacy would be for America and the Arab states to confirm that this is roughly how they see a final agreement. They might thus reassure Palestinians that they will get a fair deal, and assuage Israeli fears of being confronted with excessive demands. At the very least, the Arabs should indicate that their Beirut initiative was a starting point, not a final demand. An Arab road map might then offer Israel step-by-step rewards—such as greater diplomatic acceptance and economic co-operation—in return for each Israeli move.

Though such actions will not resolve anything at a stroke, they would over time strengthen moderates in both camps. The Arabs have more influence on Israeli opinion than they imagine, if they dared to use it.

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About sponsorship

Executive pay

A penny for your thoughts

Mar 22nd 2007
From The Economist print edition

If owners had a say over managers' pay, American capitalism would benefit

David Simonds

Get article background

IN AMERICA you can usually count on people to stand up for their rights. Oddly, though, the shareholders in American companies are like the disenfranchised citizens of a rotten borough.

Investors in capitalism's heartland have remarkably little sway over managers in the companies they own. Rather than chivvying them to perform better, investors shrug their shoulders, sell up and move on. Disputes between managers and owners are settled not so much by consultation as by litigation.

This week Congress got to work on a bill that would greatly extend shareholder democracy by giving investors a vote over executive pay. That is the area in which shareholders and managers clash most often. Horrified executives maintain that if this power is granted, special interests will use it to advance their pet causes. But the bosses should welcome this reform as being in their own interests. There is much bad feeling in America between managers and shareholders; and the best way to dispel it would be to invite investors in, not to bar the door to them.

Wage war, make peace

Managers' pay has grown at an extraordinary pace since the mid-1980s. Not everyone in the corner office matches Bob Nardelli, Home Depot's former chief, who trousered a few hundred million dollars for six years' work that was about as impressive as one of the store's kitchen units. Still, the typical manager has prospered—and continues to do very nicely indeed (see article).

But the widespread notion that this is the result of corporate misgovernance is wrong. For one thing, pay has risen even as governance has strengthened. American executives are far more tightly controlled, both by government and by shareholders, than they were in the 1960s and 1970s, when bosses' pay was relatively modest. Why did powerful executives back then fail to take advantage of something their weaker successors have so eagerly exploited?

There are simpler explanations for the executives' bonanza. The shareholder-value movement started to reward managers for profits. Shareholders have duly benefited from an era of extremely high returns.

Ever larger companies can afford to bid ever more to get the manager they want, because he will leverage even more assets. Chief executives earn a lot, to be sure, but not as much as top lawyers, investment bankers, traders and hedge-fund managers, who have seen their earnings grow faster still. And the successful managers of private-equity-owned companies do better than the bosses of publicly owned companies.

The bill before the House of Representatives' committee on financial services gives shareholders an advisory vote on managers' pay, as well as a vote if executives gain a golden parachute while their company is being sold. But if misgovernance is not the cause of the general rise in executive pay, strengthening corporate governance is surely not the solution.

It is, because the problem is not the general rise in pay but individual cases of abuse. Even if average pay is reasonable, some American bosses get outrageous salaries. That is because pay is complex and boards sometimes make mistakes. A shareholder vote might help avert them—by, for instance, curbing the excessive award of stock options in the bull market (less than 10% of which, incidentally, went to the top executives). It would also ensure that, when mistakes were made, shareholders would not be able to blame the clowns on the board, for they would be implicated too. That helps explain why some companies have already decided to give shareholders the vote.

What about those special interests? Public-sector pension funds do sometimes see executive pay as a political rather than a managerial issue. But the best way to ward them off is to get institutional shareholders involved.

British companies have been required to hold an advisory vote on pay since 2002, and this has helped defuse the hostility between shareholders and managers. Votes against managers are rare because institutional shareholders talk to firms about pay long before any confrontation threatens. American managers should try a bit of democracy too. It is, they will find, marvellous stuff.

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On nuclear tests, inflation, slavery, Japan, Hershey, food

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Evasive action

SIR – You were wrong to dismiss the concerns of those who think the Comprehensive Test-Ban Treaty is unverifiable ("Just talk to yourself", March 10th). The CTBT's monitoring centre can detect and identify non-evasive nuclear testing of 1 kiloton or greater, but it cannot detect nuclear tests below this yield nor those above the yield done evasively. Both types of tests could be carried out to assure the reliability and design of new weapons.

A likely evasion scenario is to de-couple, or conduct a nuclear test in a mined or natural cavity, the effects of which are well documented. For example, the United States conducted two nuclear tests in the Tatum salt dome located at Chilton, Mississippi. One test, conducted on December 3rd 1966, had a yield of 380 tons. The apparent seismic yield was only 5.3 tons. So using de-coupling, a 1,000-ton explosion can be made to look seismically like a 14-ton explosion. Neither the international monitoring system nor American national technical means could detect this.

A serious problem with the CTBT is that the definition of what constitutes "zero" nuclear testing remains unresolved. The United States held the position during the treaty negotiations that this meant no nuclear yield, whereas the Soviet Union contended that some level of yield would be allowed. An important question is whether Russia and others have continued to operate on the assumption that the test ban allows low-yield tests.

Kathleen Bailey
National Institute for Public Policy
Fairfax, Virginia

Inflation factors

SIR – Your leader on the recent turmoil in global stockmarkets argued that "the run-up in the prices of houses, shares and other assets does indeed reflect the belief that inflation ...is likely to stay low for a long while" ("Still not sober", March 10th). While I agree that this belief exists, it boggles the mind that any sane investor could expect low inflation in the face of oil and copper having risen by 300% in five years; wheat, corn, cement and steel at record levels; and gold, silver, nickel, lead, aluminium, tin, uranium, natural gas and just about any other commodity having rocketed over the last decade.

John Milligan
Victoria, Canada

Roots

SIR – That the slave trade was abolished by European nations which made millions from its practice is of most interest to those very same European nations ("Breaking the chains", February 24th). Much as I applaud the work of the British abolitionists I do not give them most of the credit for the freedom of black slaves. As a descendant of slaves I feel a more accurate history would include the impact of slave uprisings.

Many slaves, such as Samuel Sharpe in Jamaica, fought for their freedom. Toussaint L'Ouverture and his army freed an entire country. It was rebellions like these that ultimately forced fearful Europeans to

abolish slavery. I do not see myself as the descendant of “victims”, as your article termed them. I see myself as the descendant of heroes and wise men and women who could see what other blind fools could not—that all humans are created equal and all have a right to be free.

Olivia Mejias
London

SIR – The triumph of the human spirit was manifest in Europe's principled opposition to a practice that has been part of man's history since at least records began. I have visited the Ghanaian slave forts and read their twisted historical renditions, which blame the Europeans for all their woes and ignore the role of Africans. The British navy was still trying to block the slave trade across the Red Sea in the 1930s. There is too much breast-beating about the wrongs of some Europeans and too little historical perspective about the role of others in this appalling episode.

Ian Clements
Brighton, West Sussex

SIR – A history of slavery is incomplete without mention of the Arab world. Africans were not only shipped across the Atlantic as slaves; caravans took them to north and east Africa and on to Arab states. Slavery was not officially abolished until 1931 in Ethiopia and 1962 in Saudi Arabia.

Rufin Van Vaerenbergh
Affligem, Belgium

SIR – The claim that “up to 20m” slaves were shipped from Africa across the Atlantic is far too high. More than four decades of research puts the total estimated volume of slaves exported at roughly 11-12m between the 15th and 19th centuries.

Joe Avitable
Rochester, New York

SIR – During the 19th century slavery continued as “indentured labour”, used as a factor of production by colonial trading companies in concert with local agents. Ultimately, it wasn't Protestant conscience that eradicated slavery, but the ascendance of mass-production lines and innovations such as the steam engine.

Tze Shiung Ng
Kuala Lumpur

Prime minister's questions

SIR – Shinzo Abe's recent questioning of whether 200,000 “comfort women” were forced into prostitution should come as no surprise (“No comfort for Abe”, March 10th). Japan does not have a liberal academia that can expose the sins of the country's imperialistic past. Furthermore, an apology would be a denial of the supreme Asian value of honour and saving face. The Japanese government's refusal to apologise and make reparations will only poison relations with its Asian neighbours. As William Faulkner once said: the past is not dead, it's not even past.

Walter Lee
Newport Beach, California

The sweetest place on earth

SIR – The Hershey company did not take “its name from the town in Pennsylvania where it is based” (“Manager, offshore thyself”, March 10th). In fact, the reverse is true. Milton Snavely Hershey decided to build a factory to produce his candy bars near the place where he was born in the countryside of south-central Pennsylvania. He laid out what he considered to be a model industrial town and also set up an amusement park, both of which he modestly named after himself.

I grew up in Philadelphia, about 70 miles from Hershey. Back then, in the Depression years of the 1930s, a visit to the place was a treat for any kid. I remember touring the factory, with its pervasive sweet aroma, but my fondest memories are of the rides in Hershey Park. The town was wonderfully redolent of

chocolate. I don't know if the rollercoaster still rolls, but I bet Hershey still smells great.

Bob Nutter
Rockville, Maryland

All you can eat

SIR – Other things may also contribute to obesity, but until food habits change the epidemic will continue to grow ("Enter the obesogen", February 24th). I recently observed a neon sign in a Wisconsin shopping mall that advertised "Burritos as big as your head".

Katherine Hahn
Zurich

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Iraq

Mugged by reality

Mar 22nd 2007
From The Economist print edition

How it all went wrong in Iraq

AP

Get article background

"NEMESIS" was the word *The Economist* printed on its front cover four years ago, when jubilant Iraqis, aided by American soldiers, hauled down the big statue of Saddam Hussein in Baghdad's Firdos Square. For a moment it looked as though all the fears that had accompanied the build-up to the American-led invasion had been groundless. The defeat of Iraq's army in three weeks turned out to be exactly the "cakewalk" that some of the war's boosters predicted. And in many places Iraqis did indeed greet the American soldiers as liberators, just as Ahmed Chalabi, Iraq's best-known politician-in-exile, had promised they would.

How different it looks four years on. The invasion has been George Bush's nemesis as well as Saddam's. The lightning conquest was followed by a guerrilla and then a civil war. Talk of victory has given way to talk about how to limit a disaster. The debacle has cut short the careers of Donald Rumsfeld and Tony Blair, poisoned the Bush presidency and greatly damaged the Republican Party (see article). More important, it has inflicted fear, misery and death on its intended beneficiaries. "It is hard to imagine any post-war dispensation that could leave Iraqis less free or more miserable than they were under Mr Hussein," we said four years ago. Our imagination failed. One of the men who took a hammer to Saddam's statue told the world's media this week that although Saddam was like Stalin, the occupation is worse.

What went wrong? The most popular answer of the American neoconservatives who argued loudest for the war is that it was a good idea badly executed. Kenneth Adelman, he of the "cakewalk", has since called the Bush national-security team "among the most incompetent" of the post-war era. Others also blame the Iraqis for their inability to accept America's gift of freedom. "We have given the Iraqis a republic and they do not appear able to keep it," lamented Charles Krauthammer, a columnist for the *Washington Post*.

That excuse is too convenient by half: it is what the apologists for communism said too. But there can be no denying that the project was bungled from the start. Western intelligence failed to discover that Saddam had destroyed all his weapons of mass destruction (WMD), the removal of which was the main rationale for the war. However, the incompetence went beyond this. The war was launched by a divided administration that had no settled notion of how to run Iraq after the conquest. The general who warned

Congress that stabilising the country would require several hundred thousand troops was sacked for his prescience.

Mr Rumsfeld's one big idea seemed to be that it was not the job of the armed forces he was "transforming" to become policemen, social workers or nation- builders. As a result, he sent too few and they did nothing to prevent looters from picking clean all Iraq's public buildings the moment the regime collapsed. "Stuff happens," was the defence secretary's comment, a phrase used later as the title of an anti-war play in London's West End.

America's plans for Iraq's political transition were also rudimentary, to the extent that they existed at all. The Pentagon wanted Mr Chalabi and his fellow exiles put swiftly in charge. The State Department thought an American administration would have to be installed. State had organised a pre-invasion Future of Iraq project, but the Pentagon declined to adopt its ideas. Several knowledgeable State Department Arabists were prevented from going to Iraq because they were deemed ideologically unsound. Jay Garner, an amiable general called in from retirement to manage the transition under an understaffed ad hoc body known as the Office of Reconstruction and Humanitarian Assistance, received no intelligible instructions from Washington, and baffled the liberated Iraqis in his turn. "You're in charge," he told a gathering of 300 or so mystified tribal leaders and exiles who attended a conference soon after his arrival, hoping to discover what the future held under Iraq's new rulers.

When the Americans discovered the obvious—that Iraqis could not take charge of a state whose institutions had collapsed—the amiable General Garner was called home and replaced by a viceroy. Paul Bremer set up his Coalition Provisional Authority (CPA) inside one of Saddam's Baghdad palaces, at the heart of a fortified "green zone" cut off by tall blast walls from the life of the city. Unlike his predecessor he had firm views about what needed to be done, views which in short order produced big mistakes. He disbanded the Iraqi army and so put tens of thousands of resentful, jobless men with military training on the streets. And he turfed thousands of Baath Party members out of the bureaucracy, thereby depriving many ministries of their only trained staff.

In the end, the Americans did preside over a political transition of sorts. The CPA handed sovereignty to an interim government under Iyad Allawi, selected on the advice of the United Nations. Then, in 2005, came a year of elections. In January Iraqis voted in their first free election for a new National Assembly; they voted again in October in a referendum on a new constitution; and they voted in December to elect yet another new National Assembly under the new constitution's rules. If democratic politics were about nothing more than casting votes, Iraq would have the hang of it by now.

Unfortunately, few things are more useless than a government that cannot govern. And Iraq's government can't. For although Iraqis voted in high numbers, they voted along ethnic lines, and this produced an impasse. The outnumbered Sunnis feel locked out of a new Iraq dominated by Shias. The victorious Shia block, the United Iraqi Alliance, is itself so divided that it took its factions five months after the election of December 2005 to choose a prime minister. And his authority is limited. Nuri al-Maliki depends for a majority on members loyal to Muqtada al-Sadr, a radical anti-American Shia cleric, with a powerful militia at his disposal. The prime minister can deploy patronage, but this has made his administration into little more than a spoils system in which the individual parties, many with their own militias, use control of government ministries to extract resources for themselves.

The main reason for the government's inability to govern, however, is that it cannot stem a tidal wave of criminal and political violence. The Kurds are doing nicely in their northern enclave and much of the south is calm enough. But Baghdad and central Iraq are tangled in multiple conflicts. Many Sunnis have taken up arms against the new Shia-dominated order. Al-Qaeda is running a *jihad* against the Americans and Shias alike. By killing Shias, especially after blowing up their Askariyah shrine last February, al-Qaeda has succeeded in provoking a torrent of revenge killings. In places, in the name of "resistance" or Islam, Shia militias also attack American soldiers. A poll this week found that half of all Iraqis consider such attacks acceptable (see table). It seems extraordinary, till you remember how at a stroke the scandal of Abu Ghraib prison turned the liberators into torturers in the eyes of Iraqis. The prevalence of violence and the absence of law erodes the legitimacy of the elected government and makes it almost impossible to rebuild an economy that even before the war had been prostrated by a dozen years of UN sanctions.

What now?

It took a long time for the White House to acknowledge the bleak reality. But December's report to the new Democrat-controlled Congress of the Iraq Study Group, a bipartisan committee chaired by James Baker and Lee Hamilton, forced a change. Its succinct first sentence—"The situation in Iraq is grave and deteriorating"—made it impossible for Mr Bush to keep on saying with jutted jaw that fortitude alone could retrieve the situation. Nor, however, could he accept the group's recommendation to begin to withdraw troops and launch "a robust diplomatic effort". That would look too much like declaring defeat and going cap in hand to America's regional enemies, Iran and Syria, to sue for peace. So instead of bringing the boys home, Mr Bush decided to send more.

What to make of the "surge" now starting in Baghdad? It is reasonable for sceptics to argue that Mr Bush is merely clinging to existing policy until he leaves office, when a new president will have to clean up the mess he has made. On its own, adding between 20,000 and 30,000 American troops to the 130,000 already there hardly seems likely to turn Iraq around. All the same, some of the military architects of the surge are true believers. This is not just reinforcement, they say, but a long-overdue reversal of the whole flawed post-invasion strategy Mr Rumsfeld left behind.

From the start, the former defence secretary was convinced that the job of securing and rebuilding Iraq belonged to Iraqis. Even after his grudging acceptance that a widespread Sunni insurgency was indeed under way, American troops concentrated on minimising their own casualties while training Iraq's ragged new army to put it down. This was well beyond its ability. In recent months, since it has become clearer that parts of Mr Maliki's Shia-dominated coalition as well as parts of the police are themselves responsible for murdering many Sunnis, the strategy has made even less sense. In such circumstances, arming a government can be tantamount to taking sides in a civil war—and reducing the incentive of the side you back to make concessions for peace.

Henceforth, say the surgers, American troops will do what they should have been doing all along according to classic counter-insurgency theory. Under the direction of an energetic new commander, General David Petraeus, they will leave their bases and plant themselves in the heart of Baghdad's neighbourhoods in order to give Iraqis the security they crave. And security, they argue, is the key to everything else. Only when the killing declines will Iraq's new government be able to buttress its legitimacy, suck support away from the militias and rebuild the economy.

A few weeks into the surge, it is too early to assess the validity of this beguiling hypothesis. The number of ethnic killings by Shia gangs is reported to be falling, but Sunni car- and suicide-bombers are still killing Baghdadis in their mosques and markets. The obvious difficulty, however, is that even if the Americans have at last lighted on the right approach, General Petraeus may not be given the time to see the job through. That will almost certainly be the case if politics in both Washington and Baghdad continue to move against him.

The Democrats in Congress do not want to be seen pulling the rug from under a successful new commander. But nor are they eager to squander more lives and money on a war that many voters think America has already lost. The mood in Washington might be changed by evidence of political progress in Baghdad: the point of the surge is to stabilise the capital and so buy time for Iraq's politicians to reach a

Iraq's own voice

% of respondents*

	2007	2005
How are things generally in Iraq compared to how they were before the war?		
Much better	11	22
Somewhat better	27	24
About the same	12	13
Somewhat worse	30	21
Much worse	20	18
How safe do you feel in your neighbourhood?		
Very safe	26	63
Not very safe	41	30
Not safe at all	33	6
To what extent do you support or oppose the presence of coalition forces in Iraq?		
Strongly support	6	13
Somewhat support	16	19
Somewhat oppose	32	21
Strongly oppose	46	44
Are attacks on coalition forces acceptable?		
Acceptable	51	17†
Not acceptable	49	78†
How long do you think US and other coalition forces should remain in Iraq?		
Leave now	35	26
Remain until security is restored	38	31
Remain until Iraqi government is stronger	14	19
Remain until Iraqi security forces can operate independently	11	16
Remain longer but leave eventually	2	3
Never leave	1	1
Which political system do you think would be best for Iraq now?		
Strong leader: a government headed by one man for life	34	26
Islamic state: politicians rule according to religious principles	22	14
Democracy: government with chance for the leader to be replaced	43	57
Which of the following structures should Iraq have in the future?		
Unified country with central government in Baghdad	58	70
Regional governments with federal government in Baghdad	28	18
Separate independent states	14	9

Source: D3 Systems for BBC, ABC News, ARD German TV, *USA Today* *Poll conducted Feb 25th–March 5th; more than 2,000 people across all 18 provinces †2004

power-sharing agreement that might suck some poison out of the sectarian war. But are they capable of making such a deal? Do they even want to?

Iraq's cabinet agreed last month on how to share oil revenues between the regions. In public utterances Mr Maliki is careful to say all the right things about national reconciliation. These are encouraging pointers. The trouble is that Americans who listen in to his government's internal chatter are horrified by what they hear. Some conclude that the Shias have no real intention to share power, only to string America along while using its firepower to destroy rivals and entrench their own dominion. It is also uncertain whether the politicians who claim to speak for the Sunnis in the National Assembly are close enough to the insurgents to make them stop fighting even in the event of a political settlement. In short, time may show that the democratic structure the Americans worked so hard to install can neither run Iraq nor reconcile its warring clans.

That would mark Mr Bush's final failure The chief reason he gave for the invasion of 2003 (and the only one this newspaper accepted) was fear of Iraq's WMD. But this, admitted Paul Wolfowitz, then Mr Rumsfeld's deputy, was only “the one issue that everyone could agree on”. Others included a feeling after September 11th 2001 that America should vanquish any enemy that dared to defy it, and a belief that by turning Iraq into a democracy America could transform the Middle East, ending the rule of the autocrats, draining the swamp in which terrorism festered and promoting an Arab peace with Israel.

What next?

When the WMD turned out not to exist, Mr Bush inflated this “freedom agenda”. In his inauguration speech in 2005, after his re-election, he connected Iraq to America's “great liberating tradition” in foreign policy. Free elections had been held not only in Iraq but also in Afghanistan and the Palestinian territories. The “Cedar Revolution” turfed Syria's army out of Lebanon and American nagging resulted in an Egyptian presidential election that looked marginally less rigged than usual. But 2005 was the high point. It is now absurd to expect Iraq to serve as a democratic inspiration—it has done more to inspire *jihad*. As for proving American might, the overstretched superpower looks increasingly like a supplicant, less prone to lecture Arabs on governance than to seek help from former enemies once consigned like Syria and Iran to the “axis of evil”.

Mr Bush's rejection of the Baker-Hamilton report should not have been a surprise. Transparently admitting defeat would have forced America to negotiate from weakness. The surge, in contrast, may turn out to be a case of *sauter pour mieux reculer*: a way to strengthen America's hand before Mr Bush, or more probably his successor, co-ordinates an eventual exit with Iraq and its neighbours.

AFP

Into an unsafe future

The surge in Iraq has coincided with tougher action against Iran. America has sent an extra carrier to the Gulf and is helping to pilot a second sanctions resolution against Iran through the UN Security Council. But it is at the same time putting machinery in place that could be used to make a bargain. Officials from the two countries talked early this month in Baghdad and more senior ones expect to get together at a follow-up next month.

It seems odd after more than quarter of a century of rivalry for America to expect any help from Iran. The Islamic Republic is the big winner from Mr Bush's war. But neither Iran nor any regional power apart from al-Qaeda has an interest in the complete collapse of Iraq. The Iranians in particular worry about

what the Americans might do in such a circumstance. Ali Akbar Hashemi Rafsanjani, a former president, calls America “a wounded tiger”, all the more dangerous for its sudden weakness. Such has been Mr Bush's failure that the autocrats of the Middle East say that they are trying to rescue Iraq from America and America from itself. It really is a debacle.

If only

It is not enough to say with the neocons that this was a good idea executed badly. Their own ideas are partly to blame. Too many people in Washington were fixated on proving an ideological point: that America's values were universal and would be digested effortlessly by people a world away. But plonking an American army in the heart of the Arab world was always a gamble. It demanded the highest seriousness and careful planning. Messrs Bush and Rumsfeld chose instead to send less than half the needed soldiers and gave no proper thought to the aftermath.

What a waste. Most Iraqis rejoiced in the toppling of Saddam. They trooped in their millions to vote. What would Iraq be like now if America had approached its perilous, monumentally controversial undertaking with humility, honesty and courage? Thanks to the almost criminal negligence of Mr Bush's administration nobody, now, will ever know.

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The Iraq war

Collateral damage

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The Republican Party is among the war's victims

Getty Images

Get article background

FOUR years ago, as American troops rolled across Iraq, the Republican Party was on a roll too. Republicans not only controlled the whole of Washington (seven of the nine Supreme Court justices had been appointed by Republican presidents). They controlled the majority of governorships as well—including those of mega-states such as Florida and New York—and they were winning the war of ideas, thanks to a division of conservative think-tanks.

Republican strategists were consumed by heady visions of power without end. The “war on terror”, which was dividing the Democrats, was encouraging Republican factions to bury their differences. Karl Rove, George Bush's chief strategist, liked to compare his boss to William McKinley, the late-19th-century president who had ushered in an age of Republican dominance. Grover Norquist, an anti-tax crusader, dubbed Mr Bush “Reagan's son”.

For a moment the 2004 election seemed to justify this vision, with an improved Republican performance among blacks, Hispanics and, particularly, women. But by 2007 the Democrats were back in control of both chambers of Congress and itching to retake the White House. Fully 40% of Republicans believe that the Democrats will capture the presidency in 2008, compared with 12% of Democrats who think the Republicans will hang on to it. Ken Mehlman, the party chairman who oversaw the 2004 triumph, is now advising hedge funds on how to deal with a Democratic-leaning world. The Republicans may well be left with nothing except the solid South and a few patches of the Midwest, just as the Democrats were at the end of the 19th century.

There are plenty of reasons for the party's agonies. The Republicans fell victim to all the diseases of incumbency—from spending like drunken sailors to corruption to cronyism—and the Bush administration made a hash of responding to Hurricane Katrina. But the Iraq war lies at the heart of the party's problems. The war has deprived Mr Bush of the oxygen of popularity. A recent CBS News/*New York Times* poll found that only 39% of Americans now think that invading Iraq was the right thing to do, compared with 55% who think it was a mistake. It has also provided the Democrats with a huge stick with which to beat the opposition.

Far from uniting Republicans, the war is beginning to divide them. It is true that solid majorities of

Republicans continue to believe that embarking on the war was the right decision (76%) and that America should stay until the job is done (71%). It is also true that the Democrats remain divided on the subject. But the wedge that Mr Bush fashioned in 2004 is now being driven into his own coalition, with sections of the conservative intelligentsia in full-scale revolt.

Stephen Bainbridge, a conservative academic at the University of California, Los Angeles, has argued that Mr Bush's decision to go to war has “pissed away the conservative moment by pursuing a war of choice via policies that border on the criminally incompetent.” William Buckley, the pope of the conservative movement, says that if Mr Bush were the leader of a parliamentary system, “it would be expected that he would retire or resign”. Richard Viguerie, another conservative veteran, says that “I've never seen conservatives so downright fed-up as they are today.”

The war has eviscerated the administration's reputation for competence—and with it the idea that the Republicans have an inherent advantage as the “Daddy” party. An administration that once boasted about its clutch of CEOs will forever be remembered for phrases such as “slam dunk” (of WMD intelligence) and “Mission Accomplished”, or for disasters such as the failure to prepare Walter Reed and other military hospitals to deal with casualties. The same CBS News/*New York Times* poll found that only 28% of people approved of Mr Bush's handling of the situation in Iraq.

And that is hardly the limit of the damage. A CNN/ORC poll found that 54% of people thought that the administration had deliberately misled the American people about whether Iraq had WMD. An ABC News/*Washington Post* poll in February found that 63% of respondents did not trust the Bush administration to report honestly about possible threats from other countries. The Democratic Party will use its majority status over the next couple of years to deepen the public's unease about the administration's conduct of the war. As a result, an “R” by a candidate's name could be even more of a scarlet letter in 2008 than it was in 2006.

Mr Bush's mishandling of the war has damaged the Republican Party's two biggest advantages over the Democrats—its reputation for skilful foreign policy and for the unapologetic use of force. The likes of Richard Nixon, Henry Kissinger, George Bush senior and Brent Scowcroft clearly identified the Republicans with mastery of foreign policy. (Bob Woodward asked Mr Bush whether he had consulted his father before invading Iraq. The son replied that he had consulted a “higher father”.) By contrast, the peace wing of the Democratic Party clearly linked the Democrats with being soft on defence.

But the Iraq war has destroyed the Republicans' advantage of decades. The party is losing support even among the once solid armed services. Today only 46% of servicemen describe themselves as Republican, compared with 60% in 2004—and only 35% of them approve of the handling of the war. Voters are now much more willing to listen to the Democrats on war and peace. Barack Obama's statement in 2002—“I'm not opposed to all wars. I'm opposed to dumb wars”—is a perfect refrain for a resurgent party.

The Iraq war has also eroded the Republicans' advantage in the “war on terror”, not least because of Mr Bush's success in tying the two subjects together in the 2004 campaign. Many Republicans thought that the war on terror might have the same effect as the cold war, consolidating their party's hold on the executive branch (Democratic presidents had to wait until the end of the cold war to win two terms in the White House). But that now seems unlikely. The Republican Party's gigantic advantage in this area after September 11th has all but vanished. The same February ABC News/*Washington Post* poll found that 52% of respondents trusted the Democrats in Congress to do a better job of handling America's campaign against terrorism than Mr Bush.

At the same time, the war has taken a huge toll on the administration's domestic policies. After the 2004 election Mr Bush sketched out an ambitious agenda for avoiding the fate of previous second-term presidents and moving the country in a more Republican direction: reforming immigration and Social Security, simplifying taxes and lifting regulations. That agenda has come to almost nothing. Senior figures have been constantly distracted by dealing with the fallout from Iraq. (One reason the administration was so tardy in dealing with Katrina was that Karl Rove was worried he might become a victim of the Plame affair.) In late 2005 the administration concluded that it was impossible to push through big initiatives, such as Social Security reform, in a time of war.

The man who will pay the biggest political price for Iraq will ultimately be Mr Bush. It is hardly surprising that liberal historians debate whether he is the worst president ever. But now conservatives are beginning to play the same game. A recent poll of hard-core conservative activists found that only 3% described themselves as George Bush Republicans, compared with 79% who regarded themselves as Ronald Reagan Republicans. But the damage will not be limited to the party leader. For years to come,

the Republicans will be paying a collective price for the “stuff” that happened in Iraq.

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New York's governor

You ain't seen nothing yet

Mar 22nd 2007 | NEW YORK
From The Economist print edition

Eliot Spitzer takes on Albany

HE IS not known for being timid. As New York's attorney-general, he was called “The sheriff of Wall Street”. Last year he campaigned for governor with the promise to shake up state government. He won with 70% of the vote, and now he is trying to live up to expectations. In his first three months in office he has reformed an outdated workers'-compensation law, issued executive orders to make Albany's politics more transparent and got involved in a fight about the choice of comptroller—though, embarrassingly, he lost that one.

Now Eliot Spitzer is in the biggest fight of his term so far: an all-out brawl over health care. With the state's budget due on April 1st, the battle is the first real test of whether his forceful style will be effective in his new job. Charles Rangel, a Democratic congressman from New York City, called the melée a “food fight”. The governor seems to be enjoying himself.

If Mr Spitzer wanted to pick a fight, he has chosen the right one. Not only has health care become a prominent issue among governors, inspired by plans for universal coverage in Massachusetts and California, but New York's health system is in dire need of fixing. The state's Medicaid programme, at more than $45 billion, is America's most expensive, with spending per person more than twice the national average. New York saw a hint of progress last year, when a state commission recommended closing underused hospitals and nursing homes. But Mr Spitzer still has his work cut out.

To inch towards universal coverage, Mr Spitzer wants to extend health care to all New York's 400,000 uninsured children. His plans to curb spending are more controversial. In a testament to Albany's perversion, Mr Spitzer, a Democrat, wants to rein in costs; the Republican-led Senate, backed by the health-care lobby, does not. For years New York has subsidised inefficient hospitals and nursing homes through high Medicaid reimbursement rates, providing an incentive to provide unnecessary services. Mr Spitzer wants to begin changing this by freezing such rates. Other measures to contain costs include spending less to train interns, tightening the list of drugs covered by Medicaid and ramping up efforts to fight Medicaid fraud. In all, the governor's budget would cut health-care spending by about $1.2 billion.

Such changes are unheard of in Albany. The previous governor, George Pataki, had similar ideas, but he pursued them with the audacity of a dormouse. Mr Spitzer, by contrast, is relishing his role as a crusader against “special interests”. Enraged, the hospitals' association and the health-care workers' union have spent more than $4.5m to condemn his cuts through television advertising, rallies and mailings. They recruited Al Sharpton, an omnipresent black activist, to denounce Mr Spitzer, and on March 15th thousands of health-care workers protested outside the governor's office in Manhattan. (One hand-written sign read: “Eliot is an Idiot”.) Mr Spitzer is fighting back with characteristic zeal. He called the Senate's plan to restore his cuts “ruinous” and has spent $2m of campaign money on television ads of his own.

This tussle may extend past the budget deadline, but it will eventually end in compromise; the question is how far Mr Spitzer will retreat. If he concedes too much, he will encourage future opponents. But the governor is in a unique position to be firm. Unlike Mr Pataki, he enjoys high approval ratings—61% in February, according to a poll by Quinnipiac University. And the state Assembly, led by Democrats, seems amenable to many of his proposals.

Still, Mr Spitzer's budget only begins to address New York's health-care mess. Among the questions that remain are how to care for the elderly more efficiently and how to reform Medicaid reimbursement rates, which are now based on data that is over 14 years old, so that the programme subsidises patients, not hospitals.

The governor must also do much more to be a true reformer. His $120.6 billion budget may cut health-care costs, but it is far from fiscally conservative, says E.J. McMahon of the Manhattan Institute, a think-tank. Mr Spitzer wants to raise state spending by 7.8%, up to three times the projected rate of inflation. This increase is driven in part by the governor's proposed new infusion of money into the schools: $1.4 billion this year, part of a 40% rise over the next four years. In exchange for this munificence, schools must comply with a “contract for excellence” that requires them to show how they are spending the cash and face sanctions if they fail to improve. This is all well and good, but the plan may not be sustainable. New York already spends more on education than it does on Medicaid; the state's comptroller has warned of future budget gaps.

And though Mr Spitzer has declared himself an enemy of special interests, there are many groups he has yet to challenge. He has been reluctant, for example, to take on New York's unionised public employees, who account for one in eight of the state's workers (the national average is one in 19). The cost of their pensions is rising by the minute. Mr Spitzer, asked recently about his guns-blazing style, replied with a smirk, “That wasn't guns going.” The biggest fights are yet to come.

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Free speech in schools

Of banners and bongs

Mar 22nd 2007 | WASHINGTON, DC
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The Supreme Court mulls a schoolboy prank

AP

THE American constitution protects the right to free speech even of those who have nothing to say. Take, for example, the banner that Joseph Frederick, then an 18-year-old schoolboy, unfurled beside an Olympic parade in Alaska five years ago. It read: “Bong hits 4 Jesus”. Was he mocking Christianity? Or promoting marijuana? Neither, says Mr Frederick. He copied the slogan from a snowboard. He did not think it meant anything particular. But he calculated that it would be funny and controversial. Plus, it might get him on television.

Deborah Morse, the head teacher at Mr Frederick's high school, was not amused. She thought the banner was a deliberate attempt to subvert the school's anti-drugs policy, and worried that it would spark unruliness. Students had been excused classes so they could watch the parade. Some were already throwing snowballs and plastic bottles from the pavement.

On seeing Mr Frederick's banner, Ms Morse marched up and ordered him to furl it. When he refused, she gave him a five-day suspension. Annoyingly, the youth quoted Thomas Jefferson at her. She doubled his suspension. He sued. The case has been appealed all the way to the Supreme Court, where it was heard on March 19th.

At the heart of the case is the tension between free speech and school discipline. Precedent pulls both ways. In 1969, the Supreme Court said a school could not stop students from wearing black armbands to class to protest against the Vietnam war. Pupils do not “shed their constitutional rights...at the schoolhouse gate,” said the justices; they can say what they like so long as they do not substantially interfere with school discipline. Subsequent cases qualified this right a little. For example, in *Bethel v Fraser* in 1986, the court said a school was allowed to punish a student who gave a speech bursting with sexual innuendo.

Mr Frederick is represented by the American Civil Liberties Union. His case has several prongs. First, he was outside school, so the head teacher had no jurisdiction over him. Second, his banner was not aimed at interfering with school discipline. Third, he says he was making a statement about free speech, a right he had learned about in class but which the school did not, in his view, honour.

The school's case is that Mr Frederick was at a school-approved event on a school day, so the principal was entitled to tell him what to do. Further, since illegal drugs are harmful and the school opposed them, Mr Frederick's banner was likely to “undermine the school's basic educational mission”. And a school can

censor statements that do that, argues Kenneth Starr (of Monica Lewinsky fame), who is representing the school board pro bono.

Listening to both sides' arguments, the nine justices seemed torn. If they swallow all Mr Starr's reasoning, that would give schools vast leeway to restrict pupils' speech. That is why several conservative Christian groups are siding with the young pot enthusiast; they worry that politically-correct schools will punish devout students for expressing Biblical views about, for example, homosexuality.

On the other hand, the case is not only about free speech. It is also about money, noted John Roberts, the chief justice. Mr Frederick is suing his former head teacher personally for damages. Mr Roberts was not the only justice to worry that if teachers live in fear of a ruinous lawsuit every time they tell a pupil to be quiet, they might find it hard to keep order.

The court will probably take some time to rule. Some predict that it will uphold Mr Frederick's right to make his point, whatever it was, but scotch his attempt to squeeze damages out of Ms Morse. Mr Frederick, who was arrested for selling marijuana while at college, now teaches English in China, where free-speech-loving students are treated less gently.

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Driving licences

Too much information

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States balk at a new national standard

IN 2005 Congress considered an emergency spending bill that designated $81 billion for military spending and Asian tsunami relief. It passed easily. A politician would have to be mighty confident to vote against humanitarian aid and supporting the troops.

But grumbles have steadily grown about a law that was bundled in with the spending bill. The Real ID Act of 2005 established national standards for driving licences. By 2008, it said, every state would have to make sure its licences included “physical security features” and “a common machine readable technology”. A state would be responsible for verifying that anyone applying for a licence is in America legally. Only licences that met the new standards would be accepted by the federal government. An American who wanted to fly commercially, or do anything else for which he needed to identify himself, would end up in a queue at the Department of Motor Vehicles.

The idea was to make life harder for would-be terrorists. But the scheme will certainly make life harder for the states. Issuing new licences to millions of Americans will be a hassle. Compliance will be expensive. The Department of Homeland Security (DHS) reckons that implementing the changes will cost states up to $14.6 billion, with individuals on the line for an additional $8.5 billion. And the federal government plans to meet only a fraction of the cost.

Critics also argue that the new licences will amount to national identification cards and will contain too much information about the bearer. Immigration advocates say that the Real ID Act unfairly targets illegal immigrants. And from a security standpoint the act raises as many fears as it allays. Licences that meet the revised standards would be rich repositories of sensitive data. They might prove irresistibly tempting to identity thieves and marketing firms.

On January 25th Maine became the first state to revolt. Its legislature passed a resolution refusing to implement the Real ID Act with nearly unanimous support. On March 8th, Idaho approved a similar bill. Two dozen other states have measures pending that question the act or oppose it outright.

On March 1st the DHS issued guidelines for implementing the Real ID Act that manage to ignore most of these objections. The guidelines allow states a bit more time to implement the act. But they give no quarter on the expensive physical security features and suggest that states deal with privacy concerns on their own. And as the National Governors Association promptly noted, they “do nothing” to address the cost to states.

Senators Daniel Akaka of Hawaii and John Sununu of New Hampshire have introduced legislation that would address some of the Real ID Act's shortcomings. Congress has ample reason to pay attention. It takes a special issue to unite Wyoming, Georgia and Vermont against the federal government.

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The politics of climate change

Gore's war

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The ex-Veep lectures Congress

GLOBAL-WARMING sceptics, says Al Gore, are looking at a burning cradle and speculating that perhaps the baby is flame-resistant. Testifying before Congress on March 21st, the former vice-president was as cautious and understated as any other movie star. Mankind faces “a planetary emergency”, he said; “a crisis that threatens the survival of our civilisation and the habitability of the Earth.”

He proposed a series of measures that might ward off the environmental apocalypse. First, freeze America's level of carbon dioxide emissions immediately, and then reduce it by 90% by 2050. Second, tear up the tax code. Without altering the total tax burden, Mr Gore thinks America should replace taxes on employment and production with taxes on pollution, particularly carbon dioxide.

Third, use public money to help the poor make the transition to a low-carbon lifestyle. Fourth, forge a strong global treaty to cut emissions and put it into effect by 2010, two years earlier than currently envisaged. Fifth, stop building new coal-fired power plants, unless they can capture and sequester the carbon they emit.

With the Democrats in control of Congress, environmentalists are more optimistic than they were last year that it might enact curbs on greenhouse gases. About a dozen bills are currently being considered. But nothing as radical as Mr Gore's proposals is likely to pass.

Few in Congress deny that the earth is getting warmer or that man is at least partly to blame. But few can agree what to do about it, either. One obstacle is cost. Though Mr Gore denies it, freezing CO2 emissions straight away would be ferociously expensive. That worries both parties. One Republican congressman fretted that Mr Gore's plan would mean no new industry, no new cars and no new people in America. John Dingell, a Democrat from the Detroit suburbs, lamented the rows of empty houses he sees in the city since the American car industry fell on hard times.

Another obstacle is inertia. If Congress were creating a tax code from scratch, it might well discourage pollution rather than work, as Mr Gore demands. But since it is not starting from scratch, such a big change will hurt a lot of people now in pursuit of benefits a generation hence.

A third obstacle is that many in Congress are reluctant to make big sacrifices if China and India do not also sign up to them, which neither wants to. Mr Gore says it is up to America to show leadership.

The Democrats have two options. They can push now for the toughest carbon-curbing law that will survive a filibuster in the Senate and a possible veto by President George Bush. Or they can wait two years and hope to pass something tougher in 2009, with someone greener in the White House. Mr Gore says there is no time to waste, but Congress may waste it anyway.

Meanwhile, Mr Gore appears to be enjoying the limelight. He says he will not seek the presidency again, but many Democrats wish he would. Since he quit politics for advocacy, he has sounded more passionate and less calculating than Hillary Clinton, the front-runner for the Democratic nomination. But still, only 7% of Americans think the environment or global warming should be the government's priority.

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Los Angeles architecture

From Persian folly to boring boxes

Mar 22nd 2007 | LOS ANGELES
From The Economist print edition

Plans to make Lala Land look like anywhere else, almost

THE house that Hamid Omrani built in Elm Drive has the bulk of an iceberg and the appearance of a wedding cake. Sumptuous balconies jut out of the cream-coloured structure. Corinthian columns prop up the bulging roof. “Everybody likes columns,” explains Mr Omrani. Everybody, that is, apart from local officials, who now frown on such architectural confections, and the Los Angeles planning department, which this week opened public hearings on a plan that would bar houses like it from being built in much of the city.

Los Angeles has long been an architectural free-for-all. Until recently, just about anything could be knocked down and replaced with just about anything else. The lack of control has produced undistinguished offices but an exuberant hodge-podge of housing styles. Walking south on Palm Drive from the corner of Burton Way in Beverly Hills, for example, the first four properties you pass are an Italian villa, a Tudor house, a Spanish-style bungalow and a columned mansion. By the mid-1960s, observed Alison Lurie, a novelist, the city looked “like a stage set for some lavish comic opera”.

As the city matures, though, it is turning conservative. It began labelling districts as “historic” in 1983, and the pace of preservation has increased in recent years. There are currently 22 historic neighbourhoods, containing some 14,000 properties, where boards vet plans for demolition and ensure that new buildings do not spoil the overall look of the area. Another 16 districts are waiting to join the club.

In some places politicians have gone further. Beverly Hills and San Marino have adopted design codes that make it hard to gain permission for new houses that are not stylistically “pure”. Planners in Beverly Hills nod through English-style cottages and *faux* Normandy farmhouses, because houses like those were being built before the second world war. The city's style catalogue has nothing to say about the ornate “Persian palaces” created more recently by builders such as Mr Omrani, and clearly anticipates that no more will be built.

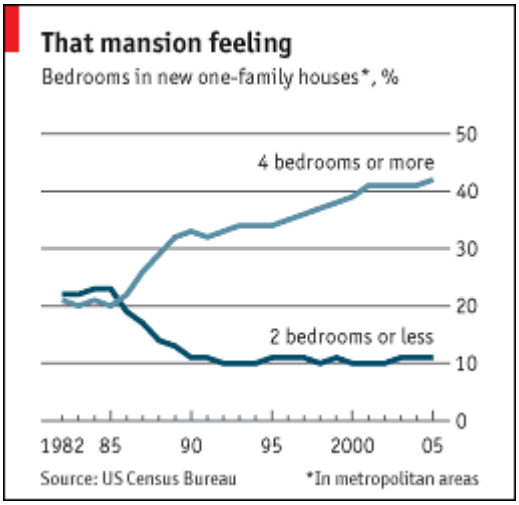
Compared with such finicky restrictions on architectural freedom, the measure proposed by the Los Angeles planning department is a wrecking ball. Following the lead of small, stylish settlements elsewhere, it wants to cut new buildings down to size. At present the owner of a 5,000 square-foot (465 square-metre) lot in a residential district is allowed to build a three-storey house with a floor area of 7,020 square feet. The planning department suggests restricting the floor area of a house on such a lot to 3,088 square feet—less than half the present size.

Increasing prosperity means the average American home is expanding (see chart). In Los Angeles, many of the big-house-builders are immigrants, who tend to have larger, more cohesive families. Yet even those who oppose restrictions believe that further limits on house size are inevitable. The fear that gardens will be shaded and privacy intruded on is simply too strong. Charlotte Laws, an estate agent who represents a district in the San Fernando Valley, says that when several options for building controls were presented to local people, they plumped for the most restrictive.

Mr Omrani, who, like many of his clients, is an Iranian Jew, is furious. “If I wanted to have mullahs telling me what to do, I wouldn't have left Iran,” he growls. Yet, like others, he is trying

to adapt to the growing list of controls by reining in designs and advising clients to remodel rather than rebuild. The result of the drift to preservation, he predicts, will be a blander city, less appealing to immigrants.

Perhaps only from some angles. A house where Leonard Bernstein, the composer, once lived is being replaced by an edifice that looks, from the front, like a conventional Beaux Arts mansion. But drive round to the back and it is clear that a different aesthetic prevails. Although only half-built, the roof has already buckled and bulged into a shape characteristic of the despised Persian palace.



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American idiocracy

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Why the immigration system needs urgent fixing

Peter Schrank

ONE OF the many memorable scenes in “The Namesake”, an excellent new film based on Jhumpa Lahiri's book and directed by Mira Nair of “Monsoon Wedding” fame, deals with a young Bengali bride and a bowl of Rice Krispies. The young woman has swapped her happy life and extended family in Calcutta for an arranged marriage and a lonely apartment in New York. When her husband, Ashoke Ganguli, leaves home early to work on his PhD thesis, she is left alone to grapple with the mystery of the American breakfast. She fills a bowl with Rice Krispies—and then covers them with curry powder and peanuts.

“The Namesake” is a moving study of the human side of immigration. But it is also a success story. Mr Ganguli snags an academic job, fathers two perfect children, moves to the suburbs and acquires an entourage of Bengali friends. His son, who is lumbered with the name Gogol Ganguli, studies architecture at Yale and acquires an All-American girlfriend, rich, blonde and well-connected.

Mr Ganguli is part of a huge army of immigrants who have brought their brains and enthusiasm to the United States—not just Indians and Pakistanis but also Chinese, Koreans and Europeans. America's high-tech industries are powered by foreign brains. Almost a third of Silicon Valley start-ups since 1995 were founded by Indians or Chinese. They also power America's great universities, particularly the science departments. About 40% of people earning PhDs in computer science and engineering are foreign-born.

You might imagine that America would welcome such talented people. But the national debate on immigration has recently acquired a bilious tone, focused overwhelmingly on the threat of illegal immigration. A country that has been built on immigrant labour is now building fences and demonising foreigners, almost as if it did not need them.

America also makes life difficult for them. Since the mid-1960s the immigration system has been skewed to uniting families rather than to attracting talent. And in recent years it has been driven by a combination of fear of terrorism and rising protectionism. In 2003 Congress reduced the number of H1B visas (temporary visas for highly skilled workers) from about 200,000—well below the number needed—to 65,000.

Potential graduate students and high-tech workers tell nightmare stories of waiting for months for the right bits of paper. And high-tech companies relentlessly complain about not being able to get visas for some of the world's best brains. A few attempts have been made to fix the system. Bill Gates and other high-tech barons have lobbied Congress to create a more flexible process and make it easier for foreign students to stay in America on graduation. But so far all attempts to sort out legal immigration have been swamped by Congress's inability to deal with the illegal kind.

America's legal immigration system is falling apart at just the time when talented foreigners have more choice than ever. Many other countries—including Australia, Canada, Britain, Germany and even France—are bending over backwards to attract talented people. European companies can easily draw on the skills of an entire continent, thanks to the free movement of labour there. At the same time the Indian and Chinese economies are booming. Indian companies such as Infosys and Wipro have California-style campuses, state-of-the-art equipment and generous pay packets (which, incidentally, allow employees to afford a house full of servants). American multinationals such as Microsoft are establishing research and development facilities across the developing world. Indians and Chinese were once willing to put up with any humiliation for a chance of a career in the United States. Now they have more and more choices back home.

Missing two worlds

This raises once again the main theme of “The Namesake”—the human side of immigration. The film reminds its audience that immigration is a traumatic experience as well as a liberating one. This is not just because leaving the rest of your family half a world away is hard. It is also because it poses difficult questions of identity.

Mr Ganguli and his wife find their children becoming strangers to them—revelling in American pop culture and embarrassed by the Bengali community's idiosyncratic ways. But the children also endure a hidden war between their Bengali and American selves. Gogol at first turns his back on his immigrant family, finding it much more glamorous to hang out with his girlfriend's family in Manhattan and Oyster Bay, before rediscovering his Bengali roots when his father dies. His mother returns to Calcutta with an immigrant's lament: she has spent the past 25 years missing India and will spend the next 25 missing America.

There are still good reasons for immigrants to put themselves through all this. America has the world's greatest universities and biggest opportunities for the truly talented. But American officialdom needs to stop thinking that people will tolerate any humiliation to work there. Uprooting yourself from your native culture is difficult enough, without having to deal with unnecessary bureaucratic obstacles. America also needs to realise what will happen if the immigrants stop coming. University departments will grind to a halt. High-tech companies will be starved of personnel. New York could find itself eclipsed by London as the world's financial hub.

“The Namesake” is worth watching for many reasons. It is a compelling study of personal identity. It features some of the most talented Indian actors in the business. But it is also an excuse for a thought experiment: imagine how much poorer America would be without the likes of Mr Ganguli.

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Colombia

The perils of “parapolitics”

Mar 22nd 2007 | BOGOTÁ AND MARÍA LA BAJA
From The Economist print edition

EPA

After four years in which he transformed his country, Álvaro Uribe is running into problems. Some of them are symptoms of success

Get article background

ON THE outskirts of María la Baja, a nondescript town on Colombia's swelteringly hot Caribbean coast, the road is lined with palm-thatched mud huts. They are the new homes of some 7,000 people displaced by violence from their small farms in the nearby hills. They say that their problems began when the guerrillas of the Revolutionary Armed Forces of Colombia (FARC) appeared in the hills in 2000, stealing their cattle. Matters deteriorated further when right-wing paramilitaries began to kill people whom they thought were guerrillas and forced others to sell or yield their land at gunpoint.

But in the past couple of years “things have improved a lot,” says Carlos Ortiz, one of their leaders. The reason: on July 14th 2005, the local paramilitary group handed over its weapons and disbanded under a peace agreement with the government of President Álvaro Uribe in which some 30,000 of the militiamen have demobilised across the country. As part of Mr Uribe's security build-up, marines have set up a base on the edge of the town, while police patrol the main road north to the port of Cartagena.

“We go back to our farms by day now,” says Julio César Azeredo, another of the displaced. But, he adds, “it's not safe to stay at night.” If this corner of northern Colombia is no longer marked by the bloody massacres of a few years ago, its new-found peace is fragile. “The people have lost confidence in everyone, they don't trust any authority,” says Giuseppe Svafrena, an Italian Catholic priest who is helping them.

Fragile it may be, but the improvement in security in places like María la Baja is real enough. On the strength of it, Mr Uribe secured a second four-year term with a landslide 62% of the vote in an election last May. But his second term is proving to be more complicated than his first.

Mr Uribe faces two immediate problems. One involves the future of the former paramilitaries, and the risk that many return to violent crime. The other involves their past: the government has been rocked by a series of revelations of links between politicians, officials and the paramilitaries. Those revelations (dubbed “parapolitics”) risk doing serious damage to Mr Uribe's standing abroad, and especially in the United States. But for most Colombians the more pressing issue is consolidating the gains in security. In opinion polls some 70% of respondents continue to support Mr Uribe, despite the parapolitics scandal. To

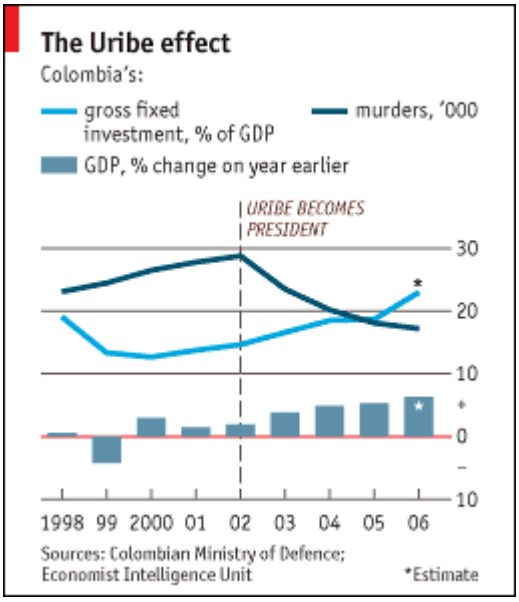
understand why requires some recent history.

During the 1980s and 1990s, the left-wing guerrillas of the FARC and its smaller rival, the ELN, grew steadily, reaching a peak of almost 20,000 troops. Their expansion owed much to money from drugs, kidnapping and extortion. They were also helped by Colombia's impossible geography and relatively weak state. The flip side of a long democratic tradition has been that Colombia's politicians never allowed the army to become strong.

In response, some army commanders and landowners formed paramilitary militias (known as "self-defence" groups) to fight the guerrillas. Yet some of these were quickly taken over by drug-traffickers and many imposed a reign of terror equal to or worse than that of the guerrillas. Colombia began to look like a failed state. That prompted Andrés Pastrana, Mr Uribe's predecessor, to start to strengthen the security forces and to seek American aid.

Mr Uribe was elected on a pledge to get tough after the FARC had shown no interest in peace in three years of talks with Mr Pastrana. He has expanded the security forces by a third, adding 60,000 troops and 30,000 extra police. He placed permanent police detachments in 150 municipalities (out of a total of 1,080) that lacked them. He created a new force of 20,000 part-time "popular soldiers" for local guard duties. Six new mountain battalions occupied the high Andean massifs which had served as corridors and refuges for the FARC. He turned the army into an offensive force, with nine new mobile brigades.

All this changed the course of the war. The FARC were driven from central Colombia, from the populated triangle marked by its three main cities, Bogotá, Medellín and Cali. For the first time in years, Colombians can drive between most of the country's cities without risk of kidnap or hold-up. Partly as a result, the economy has rebounded as businesses from oil companies to manufacturers ramp up investment (see chart). "My administration began the process of taking back the country," Mr Uribe says.



This security build-up and Mr Uribe's reputation as an implacable foe of the guerrillas enabled his government to persuade the paramilitaries, grouped in the United Self-Defence Forces of Colombia (AUC), to disarm. They did so under a controversial Justice and Peace Law. This stipulates that those accused of massacres or other barbarous acts can benefit from a reduced sentence (of no more than eight years) if they confess and surrender illegally obtained assets. The biggest incentive is that the government will not extradite them to face drugs charges in the United States as long as they co-operate.

This peace process has been highly controversial. One set of criticisms concerns its terms and another its implementation. Many human-rights groups, the paramilitaries' victims and much of the opposition considered the law too lenient and its application too lax. So did the Constitutional Court, which stiffened the law.

Only last August were the top leaders jailed pending court hearings. Rafael Pardo, a Liberal senator who broke with the president over the law, says that he thinks the paramilitaries have demobilised their counter-insurgency apparatus and moved out of drugs to avoid extradition but are moving, unchecked, into other crime rackets.

Double standards

Mr Uribe's defenders argue that Colombia is doing something which no other country has managed. "It's a peace process with an undefeated military group in which justice is being applied with no amnesty," says Eduardo Pizarro, who heads the government's reconciliation commission. Mr Uribe accuses his critics of double standards, since they never complained about (and some benefited from) past peace talks with guerrillas in which total amnesties were offered.

But the process is certainly a messy one. The attorney-general's office—a branch of the judiciary rather than the executive in Colombia—has been swamped. A special unit of 35 attorneys has been set up, but

it needs more staff and resources. Some 25,000 people have registered as victims of the paramilitaries. Mario Iguarán, the attorney-general, says that charges may eventually be brought against up to 400 of the leaders; he hopes to begin cases against 57 jailed chiefs this year.

The government's scheme to integrate the former paramilitaries into civilian life has been flawed. They receive a monthly stipend of up to 358,000 pesos ($162), but two-thirds of them have yet to receive promised training and only two-fifths have jobs. The government did the demobilisations “with a system which was only just being created and the system collapsed,” says Frank Pearl, whom Mr Uribe recruited from the private sector last year to sort out the programme.

The big fear is that many will return to violence. The best estimates are that between 2,500 and 3,600 have joined “second-generation” paramilitary groups. But officials say that some of these are drug-trafficking outfits or purely criminal bands.

For all its flaws, Colombia's peace process has quickly acquired a momentum of its own. One of the strongest signs of that is the parapolitics scandal. This began when police arrested a paramilitary leader who had failed to rendezvous in a designated area, confiscating his computer. This contained a treasure trove of information concerning the political contacts of the paramilitaries, who once boasted that they controlled a third of Colombia's Congress.

The revelations are an embarrassment to Mr Uribe. The ten politicians (nine legislators and a provincial governor) so far arrested, all from the north coast, belong to parties that support him. But most of the allegations against them date from 2002, when they backed the official Liberal candidate against Mr Uribe, who ran as an independent. More damaging is the arrest of Jorge Noguera, whom the president named to head the intelligence service.

Mr Uribe's critics have seized on all this to argue that the president is in cahoots with the paramilitaries. But there is no evidence. The president counters that he has supported judicial investigations and full confessions by the paramilitaries. “The country needs to know in depth the tragedy...to realise what is the future we need: a country of institutions, without guerrillas, paramilitaries, drug-traffickers and corruption,” he said in an interview with *The Economist.* If Mr Noguera is found guilty, Mr Uribe promises to apologise.

That the parapolitics investigations have got so far is in part a result of greater security. “Witnesses are coming forward because they do not have to fear,” says Mr Iguarán. “Who would have dared before to go to the district attorney or the judge and declare that the chief of the AUC was in league with the government, the mayor or a congressman? It's an unanticipated consequence of the Justice and Peace Law.”

It also shows how widespread penetration of politics and government by the paramilitaries was. Officials are quietly attempting a similar clean-up of the armed forces. A decorated colonel was charged before the civilian courts last year after subordinates said that he passed off murdered civilians as dead guerrillas. The defence minister, Juan Manuel Santos, is easing out other officers and working on reforms of military training. He says that control of territory, rather than bodycount, will henceforth be the army's

performance criterion.

Colombia is only at the beginning of a long and difficult road to peace. Cleaning up the army is a necessary condition for vanquishing the paramilitaries completely, argues Alejandro Reyes, a sociologist at Bogotá's Rosario university. “Otherwise the civilian population won't collaborate with the security forces.”

Such collaboration is vital. The FARC are diminished but unbeaten. They think history is going their way: Hugo Chávez in Venezuela has expressed sympathy for them in the past; so has Rafael Correa, Ecuador's new president. It will take more fighting to persuade them to negotiate, let alone submit to the Justice and Peace Law.

And parapolitics risks weakening Mr Uribe's grip on Congress. A tax reform that would have raised government revenues has been watered down. The government did manage to renew a wealth tax which should provide $4 billion over the next four years. That money will go into more helicopters, and surveillance gear to try to track down the FARC leadership.

The other task is to achieve lasting security in places like María la Baja. There Pedro Vásquez, a former policeman who spent seven years as a paramilitary leader, says that townspeople still come to him to complain of crimes and extortion “because they don't trust the police”. Some of his former troops want to return to action, something he doesn't want to do.

Carlos Gaviria of the centre-left Democratic Pole, Mr Uribe's defeated opponent in last year's election, says more is needed than just the presence of the army. The state should be present, too, with “schools, hospitals and job-creation”.

Colombia's peace process has hitherto relied on the driving will of the president, a workaholic whose face is grey with permanent fatigue. Lacking are teamwork and institutions. Luis Alfonso Hoyos, who heads the president's social-development agency, points proudly to a situation-room next to his office where representatives from 13 ministries co-ordinate policy and action. But that is in Bogotá, a long way from places like María la Baja.

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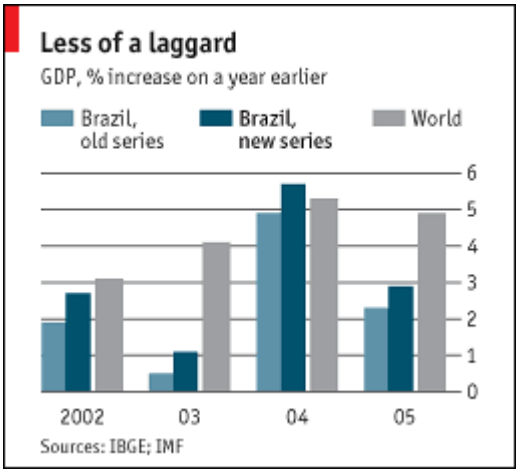
Brazil's economy

Bigger than thought

Mar 22nd 2007 | SÃO PAULO
From The Economist print edition

An underestimated pay-off from economic reform



WHEN it comes to economic growth, Brazil has long been seen as something of a laggard. But it turns out that the country's economy in 2005 was 10.9% bigger than previously thought and has grown since 2000 at an annual average rate of 3%, rather than 2.6%. That still lags the world (see chart) but is a bit more respectable.

So, at least, reckons the government's statistics institute, IBGE. It has redone its sums, relying more on data from annual surveys and less on dubious rules of thumb. In particular, it now thinks that services account for 64% of GDP, rather than 54%.

A bigger number for the economy changes several important ratios. ABN AMRO, a bank, reckons that net public debt was probably 45% of GDP last year rather than 50%, which may help Brazil's credit rating. The notoriously onerous tax burden was slightly lighter than it seemed: in 2003 taxes claimed 32% of GDP rather than 34%.

But the problem of under-investment looks more pronounced. Gross spending on fixed capital was just 16.3% of GDP in 2005, compared with an earlier estimate of 19.9%. Investment may be more productive—spending on machines and equipment rose as a share of GDP while construction fell—but the overall rate is still too low to produce tigerish growth.

There are other reasons to think that Brazil is better off than generally realised. In a recent paper*, two IMF economists argue that official data “grossly underestimate” the growth of household income. Brazil's economic opening in the early 1990s lowered prices and improved the quality and availability of goods, changes that were largely missed by the consumer-price index. Using data about what people actually consumed, the economists estimate that income per head grew 4½% a year between 1987 and 2002 compared with the official figure of 1½%, with the poor benefiting most. That makes Brazil look better; it makes economic reform look better, too.

*“The Myth of Post-Reform Income Stagnation in Brazil”, by Irineu de Carvalho Filho and Marcos Chamon

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Canada

Family viewing

Mar 22nd 2007 | OTTAWA
From The Economist print edition

A politically astute budget

Reuters

Flaherty gets his skates on

AS THE finance minister of a precarious minority government, Jim Flaherty had to take as much notice of politics as of the economy in delivering his budget on March 19th. So it was no surprise that he sprinkled largesse, doled out tax breaks to “working families” and small businesses, and even tried to silence provincial whinging with extra lashings of cash. He could do all this because Canada's financial position is strong. He announced the tenth successive annual fiscal surplus.

The budget did little for the Conservative commitment to smaller government and lower taxes. But it was politically astute. The two biggest provinces, Ontario and Quebec, will get more federal cash. A few gestures on the environment—higher taxes on gas-guzzling cars—may blunt opposition criticism that the government isn't green. There was a nod to business in tax breaks for capital investment, aimed at improving sluggish productivity growth.

This year economic growth is expected to slow slightly, to 2.3%, mainly because of the knock-on effect of the deceleration across the border in the United States. So the budget's mild fiscal stimulus makes macroeconomic sense as well.

Mr Flaherty laughed off comparison with the policies of the previous Liberal government. But such jibes may resonate with Conservatives in western Canada, not least because he announced the gradual phasing out of tax breaks for investment in Alberta's oil sands. And increasing federal transfers to the provinces for shared programmes, such as health and education, runs contrary to the conservative principle of local tax accountability. Mr Flaherty said these transfers would end bickering between Ottawa and the provinces. Some hope: the money is being poured into “a bottomless pit of ingratitude”, says William Robson of the C.D. Howe Institute, a business think-tank. Meanwhile, business leaders worry that business taxes are relatively high, according to a report this week by the Economist Intelligence Unit, our sister company.

Stephen Harper, the Conservative prime minister, knows this. But he also knows that the opposition is unlikely to try to bring the government down over a popular budget. The working family with most to gain from the budget may be the one living at 24 Sussex Drive, the prime-ministerial residence.

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North Korea's nuclear programme

Show us the money

Mar 22nd 2007 | BEIJING
From The Economist print edition

After a brief period of amiability, North Korea spits out the dummy, throws a tantrum and toddles off

Satoshi Kambayashi

Get article background

“A HEADACHE and a hard-to-understand group.” Thus South Korea's foreign minister, Song Min-soon, this week, on the topic of North Korea's delegation to six-country talks that resumed in Beijing on March 19th. Nothing new there, and his frustration was shared by officials from America, China, Japan and Russia, the other countries trying to persuade North Korea to abandon its nuclear-weapons programme. After signing a breakthrough agreement last month, the North Koreans are stalling again.

Meeting in Beijing for the first time since the agreement was signed on February 13th, the same officials started off in upbeat mood. America had just announced that one of the biggest obstacles to progress had been removed. It had agreed that $25m held at a bank in Macau, Banco Delta Asia, could be transferred to a North Korean account at the Bank of China. The funds had been frozen in 2005 because of American accusations that they were linked to illicit dealings. Now, the Americans said, North Korea had agreed to use them for humanitarian and educational purposes.

After last month's breakthrough, the head of the International Atomic Energy Agency (IAEA), Mohamed ElBaradei, visited North Korea. He was the first official from the UN's nuclear watchdog to do so since North Korea expelled IAEA inspectors in 2003. In addition, North Korea's humourless chief negotiator in the Beijing talks, Kim Kye Gwan, had been given a hero's welcome in New York by serving and former American officials.

A rare reminder of the bad old days had been a meeting in Hanoi between North Korean and Japanese officials to discuss the abduction of Japanese citizens by North Korea in the 1970s and 80s. North Korea walked out of the talks, accusing the Japanese of insincerity. But optimists consoled themselves that at least the talks—the first between the two countries in a year—had begun. And, they recalled, negotiations over the abductions, a big political issue in Japan, have been even harder-going than the nuclear talks.

However, America's man at the talks, Christopher Hill, is beyond optimism. “If something can go wrong,” he said this week, “it often does go wrong.” By then North Korea was sulking again. The money from

Banco Delta Asia had yet to be credited to its account. Chinese and American officials tried to persuade Mr Kim that this was merely a bureaucratic hitch and that he should get on with discussions about the nuclear problem. But Mr Kim refused to join the six-party talks until the money arrived. On March 22nd the North Korean delegation went home. The other parties hoped to reconvene when North Korea had calmed down.

The tiff was about a lot more than $25m. The North Koreans are sure to be angry that a senior American Treasury official, announcing the end of an investigation into the Macau bank, accused it of turning a “blind eye” to illicit activity by North Korean-related clients. American financial institutions were barred from dealing with the bank, which has collapsed as a result of the investigation. American sanctions against the bank will continue to scare other banks around the world away from doing business with North Korea.

This might deter North Korea from fulfilling its promises: to “shut down and seal” its nuclear facilities at Yongbyon; to invite IAEA inspectors to verify this by April 14th; and by the same date to produce a list of all its nuclear projects. But there are other reasons for compliance. As a member of Japan's delegation notes, after floods last year and severe cutbacks in food aid from the country's two biggest donors, China and South Korea, North Korea's perennial food shortages have been worsening in the past few months. This, he says, is making North Korea “desperate”. South Korea suspended its humanitarian aid in response to missile tests by North Korea last July. Despite an offer this week to restart shipments of fertiliser to the North this month, Seoul has indicated that aid will not be fully resumed without progress on the nuclear issue.

But North Korea has toughed out hard times before. Jean-Pierre de Margerie, the head of the UN's World Food Programme (WFP) in Pyongyang, says that “food crises” could emerge in parts of the country this year, particularly in the north-east where some 15% of the population live. However, he says the country is still “pretty far away” from the famine of the mid-1990s that killed hundreds of thousands of people. North Korea has shown no sign of eagerness for the WFP to expand its activities, which it was forced to curtail massively after North Korea announced in 2005 that it no longer needed international food aid. The WFP is now denied access to the hunger-stricken north-east.

Even if North Korea gets its frozen funds back soon, there are still plenty more hurdles on the way to fulfilling the first part of the February 13th accord—the sealing of the Yongbyon facilities—let alone the rest of the agreement, which calls for the complete “disablement” of all nuclear projects. The Americans say North Korea must account for the alleged uranium-enrichment programme that led to the current crisis. North Korea still denies it has one.

Honest accounting is hardly North Korea's strongpoint. This month the UN Development Programme suspended its operations in North Korea following allegations that North Korea was misusing funds provided by the agency. But it will also be difficult to prove that North Korea is definitely lying about the uranium. As a Japanese official says, “we can't prove it with PowerPoints”. Especially not, he might have added, to an empty chair.

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China's orphans

Party girl

Mar 22nd 2007 | BEIJING
From The Economist print edition

An orphan by any other name

AP

LIFE in China's orphanages can be bad enough, but life thereafter can be tough too. In much of China, children in state care are given unusual surnames that clearly identify them as orphans. Common choices are *Dang* meaning “party” (the Communist one, naturally), or *Guo* meaning “country” or “state”. Those saddled with these names face a lifetime of funny looks, or a bureaucratic quagmire trying to change them.

In February last year, the north-eastern city of Dalian caused a nationwide stir when it announced that it would no longer give all girl orphans the surname *Dang* and boys *Guo*. This had been the city's practice for 30 years, the legacy of an era when being called Comrade Party or Comrade State blended in more with the Orwellian spirit of the time. Party and State are surnames with ancient origins (long before the Communist Party was founded *Dang* meant simply a faction). But they are rare outside orphanages. Dalian said that henceforth only common surnames would be used.

After the fanfare with which Dalian ditched the Party/State naming system, others have been changing their policies too. Early last year, the southern city of Guangzhou stopped giving its orphans the surname *Guang* (the first character of the city's name) and given names after the district where they were found. This year nearby Dongguan stopped calling its orphans *Guan*, the second character of its name. This followed a complaint about the naming system raised by an adviser to the city's legislature. In January the northern city of Taiyuan gave up its practice of calling all orphans Party.

But there are a few, at least, who still regard the names Party or State as badges of honour. Last year, on the 30th anniversary of an earthquake that killed perhaps 600,000 people in Tangshan, near Beijing, the official press reported (approvingly) that a quake orphan surnamed Party had just joined the party and would not dream of changing her name to the one she was born with. In February, the party chief of the southern city of Zhanjiang met a group of local orphans, all surnamed *Guo*. A photographer asked the name of one of them. “Guo Yuqun,” came the reply. Anxious to distinguish the surname from a more common one also pronounced *Guo,* the orphan went on: “that's *Guo* meaning state”. Proudly, of course.

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Malaysia

Cleaning up?

Mar 22nd 2007 | BANGKOK
From The Economist print edition

Sleaze saps the prime minister's election prospects

CHEERY statements on the economy by Malaysian ministers and the pro-government press are prompting speculation that the prime minister, Abdullah Badawi, will call an election this year, even though he need not do so until 2009. The economy is doing fairly well—although economists think growth will be perhaps 5.5% this year, not 6% as the government predicts. However, hanging over Mr Badawi is his failure to keep his promise to curb official corruption. Two surveys out this month suggest that little progress is being made on this front. Worse, some big sleaze scandals have broken, suggesting that the rot reaches close to the top.

The man who is supposed to lead the clean-up, Zulkipli Mat Noor, the head of the country's Anti-Corruption Agency (ACA), has himself been accused of illicit enrichment by a former underling. In a separate case, a deputy police minister is accused of taking bribes to set criminal suspects free. Mr Badawi has rejected calls to suspend the two officials while the allegations, which both deny, are investigated.

If all this were not disturbing enough, a gruesome murder case involving a government adviser, due in court in June, may prove even more incendiary. Two members of an elite police unit are accused of killing a Mongolian fashion model, whose corpse was apparently blown up with explosives. Abdul Razak Baginda, a political analyst, is accused of abetting them. Mr Razak Baginda is close to Mr Badawi's deputy as prime minister, Najib Razak, who also oversees the police unit in question. Though Mr Najib has not been accused of any wrongdoing, there is speculation that the trial could force his resignation.

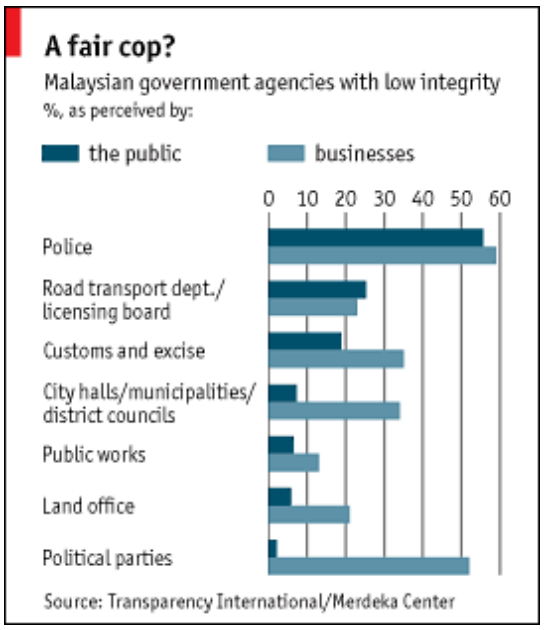
It is widely believed that Mr Badawi doubts his deputy's loyalty, and many observers think he might not be too downcast to see a potential challenger brought down. None of the present rash of scandals has cast doubt on Mr Badawi's own integrity. Even so, the rising tide of sleaze seems likely to leave a permanent stain on his reputation as a reformer.

A survey this month by PERC, a Hong Kong-based consultancy, shows that while some neighbouring countries—Indonesia, Thailand and the Philippines but not squeaky-clean Singapore—are seen as even more graft-ridden, corruption is perceived to have worsened in Malaysia since last year. The prime minister has brushed such fears aside, insisting that 85% of corruption allegations prove baseless. But in truth few are properly investigated, and even when cases do reach court, proceedings can drag on for years. Mohamad Ramli Manan, the ACA inspector making accusations against his boss, has also alleged that he was earlier sidelined for refusing to drop a case against a former cabinet minister, Kasitah Gaddam, whose corruption trial has rolled on for two years.

A survey this month by Transparency International, an anti-corruption watchdog, hinted at one explanation why so few cases are cleared. It showed that both the public and businessmen see the police as by far the most corrupted institution (see chart). From business's point of view, only political parties come close (though the public, which should presumably reap the benefits, has not noticed). Reforming the police is another of Mr Badawi's broken promises. Two years ago, a royal commission he set up called for an independent police-complaints body. But the force's chiefs objected. So far they have had their way, despite sharply rising crime—murders increased by 22% last year.

Mr Badawi's governing coalition has a strong electoral machine, while the opposition remains split between Islamists and

secularists. So Mr Badawi is most unlikely to lose the election, whenever he calls it. His main threat is from plotters on his own benches, who might be tempted to move against him if public anger at sleaze and crime deprives him of the big majority he won in the last election, in 2004.



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Central Asian migration

Steppe change

Mar 22nd 2007 | ALMATY
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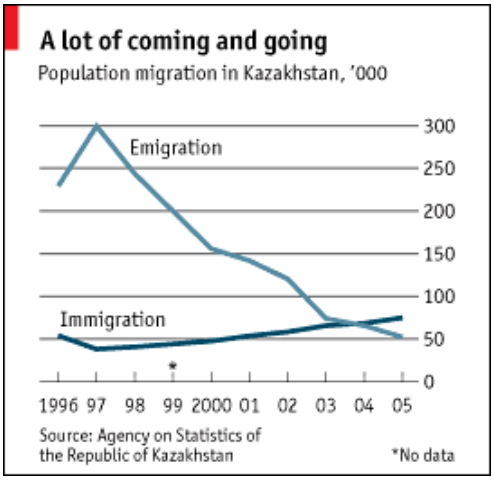
Once a place of forced exile, Kazakhstan is attracting large numbers of workers



LONG a human dumping ground, Kazakhstan is used to mass shifts of population. Josef Stalin sent his enemies to gulags on the steppe, and during the second world war deported millions of people there: Volga Germans, Chechens, Ingush, Meshketian Turks and others. Even when some were allowed to return home after his death in 1953, 2m Russians and Ukrainians were brought in to turn the harsh steppe into farmland. Kazakhs were a minority in their homeland.

When the Soviet Union collapsed, about 800,000 ethnic Germans and more than 1m Russians left the newly independent Kazakhstan. The population fell from 16.5m in 1989 to 14.9m in the late 1990s. But these days, as economic meltdown has turned to oil-fuelled boom, the human flow has reversed. A World Bank report now ranks Kazakhstan as the world's ninth-biggest destination for migrants.

Kazakhstan is still an exporter of people, mostly ethnic Russians and Germans returning to their homelands. But it has started to draw large numbers of migrants from the impoverished neighbouring Central Asian countries of Kyrgyzstan, Tajikistan, and above all Uzbekistan, as well as a few from the frontier regions of Russia and from China. They work mainly on building sites, as well as in tobacco and cotton fields and in the bazaars.

Russia, the world's second-largest recipient of migrants, continues to be the country of first choice for Central Asians, but its appeal is waning thanks to the open discrimination against non-Russians. Kazakhstan is closer and enjoys, in the south, a warmer climate. Its people are seen as more tolerant and their language, Kazakh, is closely related to Kyrgyz and Uzbek.

Politically, the regime remains authoritarian. But it has pursued market reforms and these, combined with the development of oil reserves once neglected by Moscow and high oil prices, are transforming Kazakhstan. Its economy has grown by close to 10% a year since 2000. There are an estimated 400,000 illegal migrants among a population of 15.2m.

Economic growth is changing Kazakhstani attitudes. In the south, it has become almost the norm for Kazakh farmers to keep Uzbek servants to work their land. In the view of Yekaterina Badikova, of the International Organisation for Migration in Almaty, Kazakhstan's biggest city, some are in effect kept as slaves.

The government is trying to lure these armies of *Gastarbeiter*, the German word commonly used for the migrants, out of the shadow economy. At the end of 2006, the Ministry of Interior completed a five-month pilot programme during which over 160,000 migrants were legalised. This was a third more than they had expected and brought in more than $8m in taxes.

Just a few years ago, Kazakhstanis were tickled by the news that two dozen freezing Sri Lankans had been detained by police in the middle of winter after wandering aimlessly across the snow-covered steppe in the north of the country for four days. They had been dumped there by traffickers and told they had arrived, as they had been promised, in Germany. These days traffickers might no longer need to lie. As a destination for migration, Kazakhstan is good enough for many.

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Uttar Pradesh

Caste, your vote

Mar 22nd 2007 | LUCKNOW AND THAKURDWARA
From The Economist print edition

Elections in India's most populous state promise another unstable regime

AS RAHUL GANDHI took the dais on March 20th, at Thakurdwara, western Uttar Pradesh (UP), lightning crackled and thunder boomed. “Help us return UP to the path it was on 15 years ago,” said the 37-year-old, Western-educated former management consultant, who is the son of Sonia, the leader of the Congress party. The next hope of the Nehru dynasty that has dominated Congress for five generations, he is leading its campaign for a month-long election, starting on April 7th, in India's most populous state. This is a big test for Mr Gandhi. He has done little to justify predictions that he will be prime minister after the next national elections, due in 2009. Indeed, judging by how Congress is doing in UP, the rainstorm augured less a messiah than a drenching.

AFP

Rahul's unroyal progress

Having ruled UP for most of its independent history, Congress lost it in 1989, and since has shrivelled. At the last state election, in 2002, it won 25 out of 403 seats—and then lost 15 of them through defections. In national elections in 2004, the party did much better, winning power at the head of a coalition. That gave Congress a much-needed fillip. But, despite the standing of Mr Gandhi and his mother, both of whom represent parliamentary constituencies in UP, its prospects in these elections are bleak.

Politics in UP, whose 170m people live in one of India's poorest states, at the heart of the Hindi-speaking “cow belt”, are tethered in caste. Two parties dominate. One is the ruling Samajwadi Party (SP) of Mulayam Singh Yadav, a patronage machine for members of his lowly Yadav caste and their allies, including members of the Muslim minority; it won 143 seats in 2002. The other is the Bahujan Samaj Party (BSP), which won 98 seats and performs the same function for *dalits*, those, once called “untouchables”, languishing beneath the caste system. Because neither party can muster a majority, they form unstable governments by allying variously with each other, Congress or with the Hindu-nationalist Bharatiya Janata Party (BJP), which won 88 seats in 2002.

Their governments have in a way been revolutionary. Despite decades of quotas for civil-service jobs and educational places, and other affirmative action on behalf of *dalits* and “other backward castes”, India's caste-system is written in granite, especially in the countryside. For example, the BSP's pugnacious leader, Mayawati, whose sole policy was to increase those quotas, meanwhile made alliances with high-caste groups partly to ensure that local bigwigs would not prevent her *dalit* supporters from voting.

The resulting administrations have also been riotous, vindictive and hugely corrupt. Miss Mayawati's was accused of wrongdoing over a foiled plan to append a shopping mall to the Taj Mahal, UP's—and India's—

most famous monument; Mr Yadav is under investigation, at the order of the Supreme Court, for being suspiciously rich. Organised crime, or “goondaism”, is the law in UP; unsurprisingly, given that policemen are often the biggest goons.

Both Mr Yadav and Miss Mayawati are trying to broaden their parties' appeal. At her pleasant bungalow in Lucknow, UP's capital, Miss Mayawati says the BSP is not, in fact, a party for *dalits*, but “all creeds and castes”. For the coming election, it has endorsed 86 upper-caste *brahmin* candidates, compared with 91 *dalits*. At his splendid chief minister's residence, Mr Yadav sneers at these measures, accusing his rival—but not himself—of “casteism”.

No matter: there is little reason to expect much change for UP. The upper-caste BJP may perhaps do slightly better than previously, buoyed by recent victories in other, smaller states. But in the merciful absence of serious communal violence, the BJP looks unlikely to unite the castes against its Muslim bogey. Probably neither the BSP nor the SP will win a majority, and either may form a government—with the BJP or, if Mr Gandhi exceeds expectations and wins around 50 seats, with Congress.

His campaign effort suggests that he will not. The day of the rainstorm, Mr Gandhi's main scheduled rally, outside a school, was cancelled after election officials ruled, at the last instant, that it would disturb pupils taking exams. As a crowd of 1,500—many fewer than predicted—tramped away, a cry went up: “We want Rahul!” Then, as quickly, it died down.

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India and Afghanistan

The Great Game revisited

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From The Economist print edition

India and Pakistan are playing out their rivalries in Afghanistan

IT IS easy to miss the Indian consulate in Jalalabad. Tucked away on a back street with no flag, it is just a large walled compound protected by bored Afghan guards. There is little obvious activity going on inside. Consular staff say their main job is to issue visas—about one a day, mainly for Afghans seeking medical treatment in India—and to collect exam papers from applicants for scholarships at Indian universities. “There is a lot of time for reading,” concedes one official.

Across town, however, in the Pakistani consulate, diplomats have a very different take on what the Indians are up to here, deep in Afghanistan's Pushtun belt, which Pakistan considers its own backyard. They think the Indians are spying, stirring up ethnic trouble in Pakistan and generally undermining the security of its lightly defended western border.

At the end of 2002 India reopened four consulates in Afghanistan. Pakistan's reaction to the Indians' arrival in Jalalabad and Kandahar recalls that of America when Soviet “advisers” turned up in Cuba in 1961. This is no Cuban missile crisis; tensions between India and Pakistan have eased these days. But Pakistan accuses Indian spies of whipping up secessionist sentiment among ethnic Pushtuns in Pakistan and financing a secessionist insurgency in Baluchistan. It also sees an ethnic-Tajik faction prominent in the Afghan government as anti-Pakistani Indian stooges.

Whatever their basis in fact, Pakistan's anxieties make matters worse for Afghanistan. As seen from Kabul, they help explain why Pakistan is at best tolerating and at worst actively helping the reviving Taliban in its insurgency against the government and its NATO allies. The extent of militant activity in the lawless tribal areas of Pakistan was highlighted this week by fighting between rival groups in South Waziristan, in which at least 100 people were killed. Such areas on the Afghan border provide a rear base for the Taliban.

Some outsiders sympathise with Pakistan's worries. Barnett Rubin, a regional analyst, told a committee of the American Senate this month that Pakistan's concerns about India were one of its “legitimate interests” in Afghanistan. Abdullah Abdullah, a former Afghan foreign minister seen in Pakistan as an Indian “client”,

promises that his country will never use its friendship with India to harm Pakistan's interests. But Afghanistan, he says, needs Indian aid, and “Pakistan can't veto that.”

Afghanistan is indeed in no position to spurn Indian help. The Indians have promised $750m in aid, compared with Pakistan's $150m, though Pakistan argues its true contribution includes the cost of policing the border and of playing host to more than 2m Afghan refugees.

Afghanistan's ties with India have long been friendlier than those with Pakistan. The Afghans once laid claim to Pushtun tribal areas in Pakistan and still refuse to recognise the Durand Line, the frontier drawn up by British colonial officials. For their part, Pakistan's governments have tried since the early 1970s to counter Pushtun nationalism at home by promoting the pan-Islamic extremism that has been so destabilising in Afghanistan.

Moreover, Pakistan still sees Afghanistan as “strategic depth” into which its forces might withdraw in the event of war with India. This may be outdated: because of advances in air-to-air refuelling; because both India and Pakistan now have nuclear weapons; and because they are trying to make peace. But Pakistan still wants influence in Afghanistan. It knows that NATO will not stay for ever and wants friends there when it leaves.

To date, Pakistan's best friends in Afghanistan have been the Taliban, now despised in Kabul, where many people blame Pakistan for all manner of ills. In contrast, Indian films and shows are popular, and several thousand Sikhs, the remnant of a once mighty trading community, continue to live in parts of the country.

India has an obvious interest in a stable Afghanistan. It hopes the country will one day accommodate transmission lines bringing electricity from Central Asia, as well as a pipeline for oil and gas from the region. There are two competing gas-pipeline projects: “TAPI”, running from Turkmenistan via Afghanistan to Pakistan and on to India; and another from Iran through Pakistan to India. Instability in Afghanistan is a big impediment to the first, but America opposes the second. For now, Pakistan refuses to allow Indian goods to cross its territory. But India also hankers after direct trade routes with Central Asia.

A Chinese-Pakistani joint-venture port at Gwadar in Baluchistan, which had its ceremonial opening this week, is matched by an Iranian-Indian venture to develop the “free port” at Chabahar in the Gulf of Oman. Both would require road links across Afghan territory. Indian engineers are currently connecting Afghanistan's ring road to the Iranian border. The Indian press blamed the abduction and killing in 2006 of an Indian engineer working on the project on Pakistani intelligence, after the Taliban denied involvement.

Pakistan would also benefit from Afghanistan's becoming the land bridge between India and Central Asia. But until a final resolution of its dispute with India, its calculations will be more cynical. Afghanistan is no longer, as it was under Taliban rule, a client of Pakistan. But “an unstable Afghanistan is the second-best option to a stable one ruled by your friends,” says Mr Rubin. “Both are certainly preferable to an Afghanistan ruled by your enemies.”

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Indonesia

Speechless in Bali

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An ancient tradition resists the modern world

THE bustling beaches and noisy nightlife of the Indonesian island of Bali fell silent on March 19th. The streets were deserted and businesses—even the smallest beachside stalls—were closed. Almost everyone kept indoors and lights stayed switched off all evening. It was not another bomb scare. It was *Nyepi*, the day of silence, rest and reflection that Bali's majority Hindu population observes to mark the new year.

Hinduism arrived on Bali perhaps 2,000 years ago. Its traditions there differ from those in its homeland, India, where the spring is marked with the colourful and raucous festival of *Holi*. Bali's day of silence is preceded by an evening of extreme noise, as home-made bamboo cannons are fired to scare evil spirits away from the island. Giant papier-mâché effigies called *ogoh-ogoh*, representing these demons, are paraded through the streets before being burned.

On the day itself, only local guards are allowed outdoors, to ensure everyone else stays in—including foreign visitors. Australia's government warned its tourists to expect the ban to be taken “very seriously”. So it was, even though Bali can ill afford to discourage visitors. Tourist numbers have plummeted since the bombings there by Islamist terrorists in 2002 and 2005. Some hotels put a positive spin on the curfew, inviting guests to enjoy this respite from the constant din of modern life.

Observance of *Nyepi* has become stricter in recent years. Until about ten years ago, holidaymakers were given tours of the deserted streets. Until 2000, the island's airport remained open during the holiday. The rest of Indonesia has a large Muslim majority but, despite much talk of “creeping Islamisation”, also still observes *Nyepi* as a public holiday. In 2005, when it fell on a Friday, the Muslim day of prayer, Bali's Muslims walked to their mosques and the loudspeakers that normally call Bali's Muslims to prayer were switched off. However, as parliament continues to debate a controversial “pornography bill”, it is unclear if the kissing ritual, observed enthusiastically by young Balinese on the day after *Nyepi*, will remain safe from the country's new puritans.

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Palestine

The squeeze continues

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Reuters

The international boycott of the Palestinian government has produced small political gains and caused a lot of economic damage

Get article background

THE Palestinian unity government that was sworn in on March 17th, after ten months of haggling, contained few surprises. The secular Fatah party has six ministers; Islamist Hamas, which ousted it in last year's election, has 12; the other seven went to independents and members of small, centrist parties. The final sticking-point, over who would be interior minister in charge of the massive security forces of the Palestinian Authority (PA), has been settled by giving the job to an unknown bureaucrat and creating a national security council on which both main parties have voices, and will continue to struggle for control. Hamas, for instance, has already objected to the appointment of Mohammed Dahlan, Fatah's strongman in Gaza, as the council's secretary.

That is an early sign of how fragile this accord really is. And although it may relieve the deadly factional fighting that has claimed dozens of lives, it is already clear that it will not do much to lift the year-old international boycott of the PA imposed after Hamas's election victory. Israel's government still refuses to talk to any of the ministers, though a poll has found that most Israelis think it should at least talk to the non-Hamas moderates. America is talking to the moderates, such as Salam Fayyad, the finance minister, but says that it will not restore aid to the PA unless the government meets the three familiar conditions: recognise Israel's right to exist, renounce violence and commit to previous Israel-PA agreements. (For now the unity government merely cleaves weakly to the third condition.) The European Union is doing the same. Only Norway, not a member of the EU, has restored full relations.

But having taken a year just to push Hamas into sharing power it is far from clear what more the boycott can achieve—especially as it has, in the meantime, destroyed much of what foreign donors spent years, and billions of dollars of their own taxpayers' money, trying to build.

The boycott's measurable effects are easy enough to recite. With foreign countries suspending budget support and development aid, with Israel withholding most of the roughly $800m that it has collected in the past year on the PA's behalf in customs and tax revenues, with a drastic increase in the number of checkpoints and other closures in the West Bank and a clampdown on the flow of goods in and out of Gaza (for security reasons, Israel says), Palestinian GDP per head shrank 10% last year. The number of

families living below the poverty line rose by 50%.

There are also various knock-on effects. PA services, particularly health and education, have deteriorated sharply because of supply shortages and strikes by workers. Much of the time hospitals have been seeing only emergency cases. Banks that used to lend to the PA froze credit and called in old loans, and the shrinking economy has meant less tax revenue, all adding to the fiscal squeeze.

The blockade has also undone something that donors spent years fighting for: a fiscal transparency that made the PA a leader in the Middle East. All money went into a single treasury account which Mr Fayyad, during a previous stint as finance minister, created despite stiff opposition from Yasser Arafat, the late Palestinian leader. Now, however, it can take one of three routes: to the finance ministry, to the president's office, or straight to PA employees via a “temporary international mechanism” for sending them emergency payments. That breaks down the lines of authority and accountability within the PA; employees often do not know who is paying their salaries.

The cost of a dependency culture

Just as worrying is the longer-term structural damage to the economy. The PA's hundreds of millions of dollars of debt to the private sector, which used to be a manageable burden, now risks becoming a default. If that happens, banks outside Palestine will end up paying the cost of sanctions on the PA. A blockade by banks fearful that they might be prosecuted for sending money to the PA has made it harder to do business.

Restrictions on movement and trade within the West Bank and between the West Bank and Gaza are slicing up those areas into micro-economies, thus reducing their efficiency and potential for growth. Basem Khoury of the Palestinian Federation of Industries claims that it now costs four times as much to ship a container from the West Bank to Gaza as it does to Australia or China; even allowing for some exaggeration, the costs of moving between the two are onerous and damaging.

While the economy is crumbling, the Palestinians are actually receiving more aid than ever before. To compensate for the hardships caused by Israel's revenue freeze and their own boycott, foreign donors pumped in an estimated $1.2 billion in 2006, something over 10% up from 2005, most of it in humanitarian relief directly to individuals. It may have staved off an even worse economic collapse, but aid workers on the ground worry that massive food aid and make-work programmes are debilitating local agriculture and business. “We're making people far more dependent on aid, when all they want is to prosper by their own efforts,” says David Shearer, head of the UN's Office for the Co-ordination of Humanitarian Affairs.

Mr Fayyad hopes to reduce that dependence in the long term. Donors will be looking to him to slim down the bloated public sector, with over 165,000 employees, nearly double what it was before the second *intifada* started in 2000. But it has grown thus in part to compensate for the loss of jobs in an economy that has contracted by 30%. Unless the economy is allowed to recover, trimming the PA and weaning the Palestinians off aid look exceedingly difficult.

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The Arab League

Saudi Arabia's moment

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A meeting that might actually produce something

A CERTAIN refrain tends to echo round Middle Eastern chanceries at this time of year, when Arab leaders gather for their annual summit. If they can't get their act together to do something this time, the refrain goes, it will be the end of Arab influence in the world. In fact, Arab summits, like others, rarely do produce much; but this year's event, to be held in the Saudi capital, Riyadh, next week, is raising expectations.

Several factors explain the surge in interest. Most obviously, the region is in an even bigger mess than usual. Brewing, or raging, civil wars afflict five of the 22 Arab League member states: Iraq, Sudan, Palestine, Somalia and Lebanon. At the same time non-Arab Iran, a Shia theocracy, is bidding for supremacy in a challenge to the old Sunni- and Arab-dominated order. All this at a time when America has seen its prestige and influence diminished by the Iraq debacle and its perceived pandering to Israel.

So whereas the past few summits drew increasingly meagre participation, this one is expected to get a full house (with the exception of Libya's Muammar Qaddafi, whose antics will be missed by the press but certainly not by his fellow strongmen). That is also, in part, because Arab leaders do not wish to snub the host country. Saudi Arabia has the biggest economy in the Arab world, as well as Islam's holiest sites. And these days, it can also boast the region's most energetic diplomats. Whether by inclination or default, the Saudi Arabians have increasingly displaced the United States, as well as the historical Arab diplomatic heavyweight, Egypt, as the regional power broker.

Back in 2002, it was the Saudis who pushed Arab leaders to support an offer to grant Israel recognition and peace in exchange for its withdrawal to the 1967 borders. Last month, it was Saudi pressure that forced the rival Palestinian parties, Hamas and Fatah, to compromise on a national unity government. The Saudis are also trying to resolve the stand-off in Lebanon between the ruling Sunni-led majority and its restive Hizbullah-led opponents. Part of this involves coaxing Hizbullah's backers, Iran and Syria, back into the game, by posing as a nicer cop than the punchy Bush administration.

The summit could produce some movement on all these issues. It is expected that King Abdullah will relaunch his 2002 peace initiative, this time with more support from America and less resistance from Israel. And by soothing Syria's fear of isolation from the Arab fold, fellow leaders may hope to nudge its edgy president, Bashar Assad, into greater flexibility over Lebanon.

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Iran

All hands to the pump

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Oil-rich Iran may have to ration petrol

Reuters

Much refinement, little refining

IRANIANS last week celebrated the start of their new year, but alongside the festive goldfish and fireworks displays, 1386 might bring a rise in their petrol bills. After two years of dithering, the government is at last ready to introduce rationing and a price hike to reduce a subsidy that costs the country billions of dollars a year.

Petrol rationing in a country with the world's second-largest reserves of crude oil might sound slightly strange. But Iran's big problem is a shortage of refineries; it can only satisfy about 60% of its soaring demand with locally produced petrol. It imports the rest at market prices of about 45 cents a litre—five times what motorists pay at the pumps.

Several contracts have recently been signed as part of a $15 billion upgrade of refining capacity, but the new petrol will not be available for several years. In the meantime the shortage represents a vulnerability at an unfortunate moment: Western countries are looking for ways to press Iran over its nuclear programme and there has been some talk of a future embargo on imported petrol.

The subsidy is anyway costing the country dear at a time when the economy has become the focal point of domestic opposition to President Mahmoud Ahmadinejad. A populist spending spree has fuelled inflation and unbalanced the budget. Cheap petrol also encourages enormous waste as well as smuggling to neighbouring countries where it is more expensive. Officials have suggested that raising the price could help reduce consumption by around 20%.

The fear, though, is of a further increase in inflation if prices are brought, as economists say they should be, up to the cost of domestic production, something like 20 cents a litre. There is also a political problem. Iranians often see cheap petrol as proof that the government is redistributing oil wealth back to the people—one of Mr Ahmadinejad's big election promises. Raising the price makes economic sense but is the last thing a populist government wants to do.

As a result the government and the Majlis, Iran's parliament, have spent two years bickering over how to cut the subsidy without upsetting voters. Targeted subsidies and cash gifts to poor motorists have both been considered. But the focus is now on smart cards, which would ration subsidised petrol to a few litres a week, with excess consumption being paid for at the cost of imports.

The subsidised price will also be raised by a couple of cents, but some economists say the rise is too small to make a difference. The Majlis has meanwhile thrown the problem of implementing these plans back to the government with a deadline to introduce the rationing by late May and a promise to import no more than $2.5 billion of petrol over the next year.

The question, as always, is whether this government has the stomach to implement so unpopular a policy. In the past buoyant oil revenues have allowed the government to buy (and subsidise) its way out of political trouble. But with the Majlis spoiling for an economic fight with Mr Ahmadinejad, it looks as though this time he may have to make Iran's over-enthusiastic motorists pay up.

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Zimbabwe

Houdini holds on, for now

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Zimbabweans are desperate to kick out their leader, but too divided to act

AP

Scavenging to survive in Mugabe's Zimbabwe

THE walls talk bravely enough in Harare, Zimbabwe's capital. “Vote him out” is scrawled in man-sized letters on a fence in the leafy suburb where President Robert Mugabe has his private home. On brick and tarmac across town are sprayed “MDC”, the initials of the opposition party, and the word “Change”. But flesh and blood are more vulnerable. In the past two weeks, since police shot dead a man who was calling for Mr Mugabe to go and then arrested and badly beat several opposition leaders, something close to a state of emergency has been in force.

At night plain-clothes security men prowl the townships, breaking up meetings and enforcing an unofficial curfew. All over the city uniformed police now tote semi-automatic rifles. It is popularly believed that one in ten adults works for the feared Central Intelligence Organisation (CIO), which reports directly to Mr Mugabe. Last weekend the CIO reportedly snatched the body of the slain protester from a funeral parlour to prevent his burial becoming the focus of more anti-Mugabe demonstrations. Few dare to mention the president by name. “The old man must give it a rest, the people are cross,” says a gardener, adding that the police use water-cannon and truncheons on those who speak out.

So the crackdown goes on, despite foreign criticism even from some corners of Africa that had previously kept quiet. On March 18th an opposition activist was dragged aside at Harare airport and beaten. Others were arrested when they tried to leave the country for the medical treatment they need after the beatings they had suffered earlier this month.

Optimists say that the increasing repression is evidence that Mr Mugabe is becoming desperate, that he now lacks any other means to hang on to power. Morgan Tsvangirai, the main opposition leader, whose fractured skull has become a very visible symbol of the latest round of state violence, says that the end is close for Mr Mugabe. Another MDC spokesman believes that the president has run out of tricks to ensure his survival: “We are watching Houdini finally drowning in his chains”, he says.

But that may be wishful thinking, at least if it depends on the opposition getting its act together. The MDC remains divided, penniless, without serious foreign support and unable to get people back on the streets in big numbers. Young men have thrown petrol bombs at police stations and assaulted policemen, but such acts are spontaneous defiance; little is organised. Residents of Harare, where anti-Mugabe feeling is strongest, say that they “just pray for change”, but few seem ready to do much more. Beyond

the city there have been no serious demonstrations.

Of course Zimbabweans are fed up. Most are jobless. Few wages, anyway, cover the high cost of something as mundane as taking a bus to work. At dusk the roads are lined with men and women, some with firewood or sacks of mealie-meal on their shoulders, tramping home to townships many miles away. With inflation at 1,700%, cash is being printed so fast it is all but worthless. Zimbabweans joke that theirs is the only country where millionaires go hungry. Petty crime is rising. Shop owners say staff or customers used to pilfer some 5% of their stock, but now the share is as high as one-third.

But such woes do not simply translate into political protest. Without opposition leaders to organise the discontented, Zimbabweans knuckle down and endure hardship. More and more households, struck by AIDS, are headed by children; more young people turn to prostitution and crime; more beggars and fruit-sellers patrol the streets.

Holding on to his job

And among the poverty and hopelessness, a few people are getting rich too. Ever more luxurious cars navigate Harare's potholed streets and broken traffic lights. On March 19th the country's stockmarket rose by a barely credible 569,000 points, as much in a single day as it rose in the four decades up to January 2007. Investors get short-term loans from local banks to speculate; when it all collapses, as it must, some banks will be in big trouble.

None of this means, however, that Mr Mugabe is safely in office for the long term. A real threat lies within his own ranks. Jonathan Moyo, an outspoken independent MP (but formerly the chief public apologist for the president), claims that the old man is isolated in his own party and is losing his political touch: “Mugabe's rule is finally coming to an end,” he says. He predicts that the ruling Zanu-PF party will soon split as rivals for the succession become impatient to take over.

Mr Mugabe has long been adept at dividing and ruling over his allies, but recently he has stumbled. He failed to get the party to extend his presidential term by two years. He has been virtually ignored by his party after saying that he will run again for president in an election in 2008. Instead, leading power-brokers, especially Solomon Mujuru, an old brother-in-arms, appear to be stitching together rival party factions to ditch the president. Mr Mujuru is said to worry that economic collapse is threatening his own vast wealth and is thought to have the backing of at least some of the army.

Such rumours, if true, would be a greater threat than street protests. Tantalisingly, some close to Zanu-PF's leaders even say that Mr Mujuru has been in talks with Mr Tsvangirai. Yet Mr Mugabe is a keen fighter. He is spry despite his 83 years, rising at 4am each morning and working until at least 9pm, according to a priest who sees him regularly. He has a strong incentive to hold on to power, as he fears prosecution for murder and other crimes. And some others in the party would hate to see Mr Mujuru triumph, so may help prolong Mr Mugabe's rule. Thus, as with the opposition, the rival factions of the ruling party are hobbled by their own divisions. Houdini is indeed looking troubled, but he is not out of breath yet.

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Somalia

Slipping backwards

Mar 22nd 2007 | NAIROBI
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But there is still a chance to stave off a full-blown insurgency

AFP

All too familiar in Mogadishu

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EXPERIENCE teaches that stability in Somalia depends on peace in Mogadishu. So recent events in the capital are now the cause of real concern—again. The United Nations reckons that 40,000 of the city's 2m residents have fled increasingly heavy fighting since February. On March 21st at least 15 people were killed in one fire-fight, the heaviest since the Islamist militias were chased out of the city last December. In dreadful scenes reminiscent of the shooting down of an American Black Hawk helicopter in the city in 1993, the bodies of two dead soldiers were dragged through the streets before being set alight by chanting mobs.

The violence has increased dramatically since the arrival of a Ugandan peacekeeping force. The Ugandan troops, under African Union (AU) command, have formally taken over from Ethiopia, whose troops have occupied Mogadishu since the retreat of the Islamists. The Ethiopians are unpopular with ordinary Somalis, who see them as occupiers; the Ugandans are also viewed by militants as nothing more than interfering foreigners. An Ethiopian soldier was probably among those killed on March 21st. Some Ethiopian troops have left, and those who remain have withdrawn from public view, including from the presidential palace. But they are unlikely to withdraw completely just yet.

In part, that reflects a failure of the AU. Only 4,000 of the 8,000 troops the organisation has requested for Somalia have so far been committed; of these, only the Ugandans are on the ground. It will be hard for them to pacify Mogadishu, even at full strength. The best the AU green helmets can hope for, say Somali watchers, is to secure key installations and road junctions. A Ugandan force commander says his men will patrol only in neighbourhoods where they are welcome. That will make them less of a target, but it will also put some areas of Mogadishu dangerously off-limits.

Much depends on the success of a touted national reconciliation process. Somalia's transitional government has been bullied and bankrolled into making a show of forgiveness, but it is unclear whether a national-unity conference planned for April will amount to much. Foreign diplomats say the government should reach out to moderate Islamists while excluding Mogadishu's warlords. But even with the best intentions that is a hard act to pull off. The warlords are emboldened, and may be responsible for some of the mortar attacks. They certainly see themselves as having legitimate claims to be in government.

But remnant Islamist fighters still account for most of the violence. There may be over a thousand of them in or around Mogadishu. Some have formed new jihadist groups. Gauging their strength is not easy, particularly since they have taken to paying freelance gunmen to attack government and Ethiopian positions. The more sophisticated nature of recent attacks, together with pugilistic broadcasts made by some jihadist commanders in hiding, suggest that they may have the makings of a serious insurgency.

The next few weeks will be critical. The peacekeepers need to hold their nerve. The government has to reach out to disaffected clans, especially by including them in the building of a new national army. And the Islamists could yet miscalculate, as they have done before. A grouping of Islamic courts in Mogadishu became popular last year because it opposed violence and restored order. Calling for violence and provoking disorder could swing the people back behind the government.

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Angela Merkel

Unfinished homework

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Peter Schrank

Germany's chancellor shines more brightly abroad than at home

SHE dresses more stylishly these days; a silver necklace and new hairdo add a feminine touch to the leader of the most powerful country in Europe as she struts the world stage. Everywhere she wins hearts and minds with a mix of intelligence and female modesty. Indeed, Angela Merkel's *Frauenbonus* has made her at times the most popular of post-war chancellors. Yet as she prepares for her Berlin EU jamboree this weekend, what is notable is that praise from foreigners is not translating into successes at home.

In one sense, Ms Merkel has been lucky. The economy is enjoying a recovery that owes more to the efforts of German business than to the government. She is in the limelight because of Germany's six-monthly presidency of the European Union, which will hit a high point with the Berlin declaration on March 25th, and from her G8 presidency. Yet in domestic policy she is hamstrung by an unwieldy coalition and Germany's federal structure.

The grand coalition of her Christian Democrats (CDU, plus Bavaria's CSU) and the Social Democrats (SPD), which took office in November 2005, may well limp on to the next election in 2009, but every day it seems to be hit by fresh internal ructions. The pattern has been one of clumsy last-minute compromises rather than the coherently thought-out reforms that one might look for from a government with a benign economy and weak opposition.

Last year, for instance, many in the CDU opposed a law mandating equal treatment in the workplace. February saw a revolt over a planned health fund to reallocate premiums among the 229 insurers in the state system, which will hit the better-off states. Recently the cabinet agreed to cut the corporate-tax rate from 39% to below 30%, but SPD bigwigs and even a CSU minister promptly attacked the plan.

Unlike her SPD predecessor, Gerhard Schröder, Ms Merkel can at least count on support in the Bundesrat, the upper house, where the states are represented. More than half of new laws need the approval of the Bundesrat; 11 of the 16 state premiers who sit there are in Ms Merkel's camp. Yet even within the CDU, state premiers tend to act as regional barons, not as voting fodder for the federal government. Several are potential rivals to Ms Merkel.

The chancellor seems to accept that hers is perforce a cautious, caretaker government. Her tactic is not to

identify too closely with any particular reforms and to let her ministers take the flak. When Ursula von der Leyen, the family minister, fell foul of Volker Kauder, chairman of the CDU/CSU parliamentary group, over child-care support for working mothers, Ms Merkel's backing for her minister was offered carefully at arm's length.

But Ms Merkel has pounced on one issue and made it her own: the environment. She insists that Germany must provide leadership in the reduction of carbon emissions and in clean technology. That is despite a powerful automotive lobby, which has just won concessions from the EU on emissions targets for luxury cars—with grudging help from the chancellor.

One advantage is that she can play a waiting game. Within the coalition the SPD is suffering more than the CDU. Polls put the Social Democrats well below their score in the September 2005 election. They get little credit for starting the recovery with their “Agenda 2010” reforms, which began in early 2003. The corporate-tax cut is being pushed by Peer Steinbrück, the SPD finance minister: it will not appeal to the party's soul. More naturally Social Democratic issues have been hijacked by the CDU: child care by Ms von der Leyen, the environment by Ms Merkel.

The SDP's other problem is leadership. Kurt Beck, the party boss and likely chancellor-candidate, has only a 46% approval rating in his own party. Other hopefuls are ruled out by ill-health or because they have no political base. Even sympathetic commentators say the SPD is exhausted and in need of a spell in opposition.

By contrast the CDU has a clutch of youngish pretenders biding their time as regional premiers: Roland Koch in Hesse, Christian Wulff in Lower Saxony, Günther Oettinger in Baden-Württemberg. Any of these would be eager to step up if Ms Merkel stumbles. But Ms Merkel has proved many times to be a master of *Machtkalkül*—gaining and keeping the upper hand. Friedrich Merz, one possible rival, has just announced his exit from politics.

This does not mean Ms Merkel has a clear run to the next federal election. A big shock in one of five state elections over the next 18 months could change things. It was the SPD's loss of North Rhine-Westphalia in May 2005 that led Mr Schröder to call an early federal election. In Bavaria, which votes next year, the CSU is rudderless after forcing its long-time leader, Edmund Stoiber, to step down next September.

Germany's federal structure and proportional representation make it hard for any party to win an election outright. Indeed, all post-war governments have been coalitions. Yet only one (in 1966-69) has been a grand coalition, and it was a disappointment. Usually, the coalition has taken in a big party and a smaller one, such as the Greens or Free Democrats (FDP).

There are already clear signs of pre-electioneering. The polls suggest that, if an election were held tomorrow, another grand coalition would be the likely outcome, although a CDU/CSU hook-up with the FDP is possible. But other combinations are also in people's minds.

A “Jamaica” coalition of the CDU/CSU, FDP and Greens (so-called because the party colours are those of the Jamaican flag) was floated in autumn 2005. “We should have explored the possibilities more,” says Dirk Niebel, general secretary of the FDP. Another idea is a “traffic light” coalition of the SPD, FDP and Greens. Most intriguing is the possibility that the Left Party could join with the SPD and the Greens. The biggest obstacle is Oskar Lafontaine, a Left Party leader who quit the SPD in high dudgeon: few of his former colleagues could ever work with him.

Ms Merkel's chancellorship may see foreign successes in Brussels and Washington, but its weakness is a lack of domestic achievements. Mr Schröder is winning belated praise for Agenda 2010. What will Ms Merkel boast in 2009? She may not be the first leader to find that triumphs abroad seldom sway voters at home.

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Poland and Europe

A foreign affair?

Mar 22nd 2007 | WARSAW
From The Economist print edition

The Polish government realises it needs a foreign policy, but doesn't yet have one

A FLURRY of interest in the outside world might not seem odd in one of the European Union's bigger members. But when it comes from Poland's president and prime minister, the twin brothers Lech and Jaroslaw Kaczynski, it is a pleasant surprise. The prime minister, Jaroslaw, visited the Netherlands and Denmark last week. Angela Merkel, the German chancellor, visited Poland, meeting the prime minister, speaking at Warsaw University and spending a day at President Lech's house on the Baltic coast.

This almost counts as a love-in. Polish foreign policy has been introverted, incompetent and marked by hostility to Germany since the Kaczynskis came to power in late 2005. Ms Merkel showed the value she places on improving German-Polish relations by bringing her husband, who rarely accompanies her abroad. Her main aim was to persuade the Poles to drop their resistance to this weekend's Berlin declaration celebrating the EU's 50th birthday, and to be more open to reviving the EU constitution. Poland had held out for a mention of God and the Christian tradition, but it has given up—though it will still be awkward on the constitution.

Ms Merkel seems to have persuaded the Poles that she is a sympathetic friend, not a revanchist and bullying neighbour. Her experience under totalitarian rule in communist East Germany helps. But she has also showed sensitivity to Polish concerns. The anti-ballistic missiles that America wants to base in Poland did not spoil her talks and her seaside stroll. The Polish president also avoided the knee-jerk issues of German atrocities against Poland. He made no mention of plans by a group of Germans deported from Poland after the war to open a museum. Nor did he whinge on about the planned pipeline that will pump Russian gas directly to Germany under the Baltic Sea.

Closer ties with Germany are welcome, but not enough. The Polish government's foreign-policy woes stem largely from prejudice and ignorance. Not only are the Kaczynskis untravelled and monoglot; they distrust cosmopolitans. They have sacked or intimidated any advisers or colleagues who showed too much knowledge of, or interest in, the abroad. One result is more clashes with the EU, some unnecessary, others badly managed.

The Kaczynskis are sceptical about the euro, and so of the reforms needed to join it. Their method of communication has annoyed the EU: the economics commissioner, Joaquín Almunia, recently complained that the Polish government simply didn't inform him of its economic policy. One reason is that finance ministers change with alarming frequency (the incumbent is the fourth in 18 months). The foreign minister is a close Kaczynski chum, who sees her job as relaying his views bluntly, not building diplomatic alliances.

Poland's image is worsened by the antics of the League of Polish Families, a minority coalition partner. One of its leading lights is campaigning against the teaching of evolution in schools. The party wants to ban abortion in Europe. This week the European Court of Human Rights awarded a Polish woman damages of €25,000 ($33,250) for being refused an abortion that could have saved her eyesight. The party leader, Roman Giertych, who is education minister and deputy prime minister, wants to restrict what he terms the “promotion” of homosexuality in Polish schools. To secular liberals in the rest of Europe, all this makes Poland seem a bastion of medieval barbarism.

Other issues are more substantive. The Poles are being taken to the European Court for building a motorway through a conservation area. Their insistence on sticking to the voting system agreed in the Nice treaty in 2001, rather than the new one in the draft EU constitution, grates in Brussels—and Berlin. But Poland's leaders seem to have realised that a country wishing to have any influence needs a functioning foreign policy. All they must do now is formulate one.

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Kosovo and Russia

Veto threats

Mar 22nd 2007
From The Economist print edition

Kosovo is heading for independence whatever the Russians say or do

HOW and when will Kosovo become Europe's newest state? These are questions that European and American diplomats are grappling with at the United Nations. What they are not doing is wasting time debating whether Kosovo should be independent—for it is too late to stop it.

Kosovo is home to some 2m people, at least 90% of whom are ethnic Albanians who have long demanded independence from Serbia. Since 1999 it has been under UN jurisdiction, although it is a province of Serbia. Some 14 months of UN-sponsored talks chaired by Martti Ahtisaari, a former Finnish president, have not produced a deal. So Mr Ahtisaari has unilaterally presented his plan for Kosovo's future to the UN secretary-general, Ban Ki-moon. He proposes independence for Kosovo, but with conditions, including an EU-led mission to succeed the UN one and an international overseer, whose job would be modelled on Bosnia's.

Kosovo's Albanians grudgingly accept this but its Serbs, as well as Belgrade, do not. Because jurisdiction now lies with the UN, a new UN Security Council resolution is needed to transfer powers to the EU-led mission and international overseer. But an angry (and veto-wielding) Russia insists it will not assent to the Ahtisaari plan if Belgrade does not. Indeed, Russian spokesmen say that if Mr Ahtisaari cannot find common ground between Serbia and the Kosovo Albanians, somebody else should do the job. Yet this is just a delaying tactic. The Russians know that the Serbs and Kosovo Albanians will never agree.

Mr Ahtisaari's plan is being translated into the UN's official languages, but will shortly be presented formally to the Security Council. In the meantime he is telling EU countries that this is a big test. If it is flunked, not only will Kosovo relapse into violence but also the EU will be seen as having suffered another huge foreign-policy failure. These arguments have had some success. Two sceptical countries, Spain and Slovakia, now say that EU unity counts for more than their doubts.

After years of lost interest in the Balkans, the Americans are also rolling out their heavy guns. In a recent article in the *Washington Post*, Richard Holbrooke, the American diplomat who struck the Dayton deal to end the Bosnian war, declared that “European security and stability, and Russia's relationship with the West, are on the line.” Mr Holbrooke is a private citizen but still has close ties to the State Department. Few in the Balkans believe that he is simply expressing his own views.

So it is significant that Mr Holbrooke adds what many suspect: if Russia blocks a new resolution, Kosovo will declare independence anyway—and the Americans will “probably” recognise it. Many Muslim countries will follow, though Mr Holbrooke thinks most EU countries may not. Without a new UN resolution, diplomats say the choice is not independence or not; it is between “controlled” and “uncontrolled” independence.

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Serbia's future

The costs of non-Europe

Mar 22nd 2007
From The Economist print edition

How Serbia loses from its frosty relationship with the European Union

UNNOTICED by the world, Montenegro has taken a big step in its relations with the European Union. On March 15th it signed a stabilisation and association agreement (SAA), usually the first step to EU membership. Informally, it is a stamp of approval from Brussels.

Serbia too should have an SAA by now but, because it has not arrested such war-crimes suspects as Ratko Mladic, talks were broken off last year. By contrast, Macedonia signed an SAA in 2001, before graduating to candidate status in 2005. A new study by the European Stability Initiative, a Berlin-based think-tank, shows how much difference being on the EU ladder makes.

Consider the textile industry. In Romania and Bulgaria, which joined the EU in January, textiles are booming. In part this is down to low labour costs, but it is also because they are close to the huge EU market. Macedonia's textile industry, centred on the town of Stip, has also revived. Although unemployment is generally high, there is a shortage of textile and clothing workers in Stip. In 2002 the industry employed 4,000; by the end of 2006 the number was 7,000, and it should soon be back to its 1990 level of 8,700. Greeks, Germans, Turks and Swiss are all investing in Stip.

The contrast is with Leskovac, in Serbia, once a world-famous textile town. In 1990 some 11,000 people worked in its textile and clothing factories. Now the industry employs fewer than 900. Although Serbia has attracted some foreign investment, most of it has been for lucrative privatisations. The lack of an SAA deters other investment: an EU official told a Serbian newspaper this week that Serbia had lost investment worth €1.5 billion ($2 billion) because of this.

A debate has begun in Brussels over whether to restart the SAA talks with Serbia, even if it does not produce Mr Mladic. No such luck for Bosnia. An agreement on an SAA was ready last year, but the EU will sign only if Bosnians agree on police reform—which they still have not done. This week in London, Sven Alkalaj, Bosnia's foreign minister, lamented that unless a deal is done by the end of March, EU timetables mean that “we will lose a year.”

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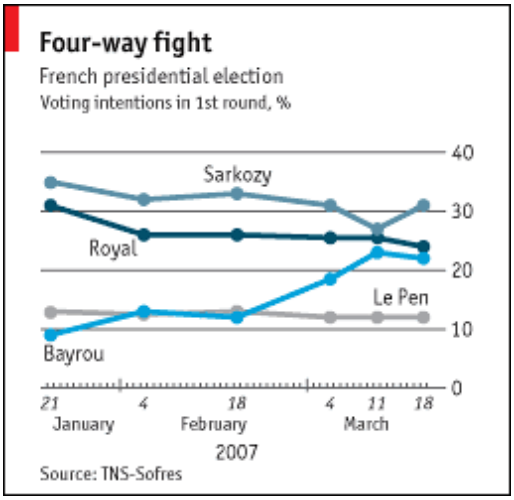
France's presidential election

La France profonde

Mar 22nd 2007 | DONZY AND SAINT-VERAIN
From The Economist print edition

A semi-rural bit of Burgundy is France's electoral weathervane

NESTLING in the rolling valleys of central France, between fields of wheat and grazing cows, the village of Donzy seems from another age. Its tractors are dated; its shops stay shut on Mondays. Its main worry is how to attract a new doctor to replace the one who has retired. Yet there is something about Donzy that captures the preoccupations of the French at large. At every presidential poll since 1981, as well as in the European referendum in 2005, its 1,700 inhabitants have voted in line with all of France.



When France swung left in 1981, behind François Mitterrand, so did Donzy. When France went for the Gaullist right in 1995, behind Jacques Chirac, so did Donzy. Its blend of rural and industrial—artisanal workshops turning out drinking straws, precision tools and umbrellas are dotted in its outskirts—characterises the gritty spirit of working France, which feels its pockets squeezed, and its future unsure.

What does Donzy make of the presidential election before the first round on April 22nd? “Everybody's talking about Bayrou; they like him because he's not on the left or the right,” a town-hall worker says of the centrist who has stormed up the polls. “But now people are beginning to ask: what is he actually proposing?”

Bernard Devin, the mayor, frets that François Bayrou, whose party has a tiny minority of parliamentary seats, would have trouble governing. “I'm not sure people have understood this yet.” A one-time teacher who says he is “of the left”, Mr Devin is no more persuaded by the Socialists' candidate, Ségolène Royal. “I don't like her,” he says bluntly. “She never talks about rural life. She is like a good mother, too oriented towards social issues. She says she wants schools to listen more to parents, but you can't listen to everybody.”

It is hard to find anyone with a good word for Ms Royal, even though all three members of parliament for the department of Nièvre are Socialists, and Mitterrand was for 22 years mayor of nearby Chateau-Chinon. In the Café du Chasseur at Saint-Vérain, a few farms away, the clients drinking their midday *vin rouge* are not keen. “She's not convincing,” says the owner, serving up an obligatory four-course meal, including *boeuf bourguignon* and chips, for €11 ($15), while keeping an eye on her television soap. “But I may have to vote for her—or for Bayrou, why not?”

The candidate nobody mentions is the National Front's Jean-Marie Le Pen. He is lying fourth in the polls, but his vote could be underestimated because of the stigma of admitting support. Despite the absence of an immigrant population, or of much social housing, Donzy gave Mr Le Pen 17% of its votes in 2002—in line with what he took nationally, and enough to win him a second-round place. The mayor puts this down to “a sort of dissatisfaction with politics”, rather than to xenophobia. “People are fed up with politicians,” he says.

By contrast, the politician on many lips is Nicolas Sarkozy, the centre-right candidate, who leads the polls. “Bayrou would just be like five more years of Chirac,” says Pierre de Jean, who runs a designer umbrella factory in Donzy. “Personally, I'll vote Sarkozy,” he adds, inspecting the laces on a black latex umbrella designed for Jean-Paul Gaultier, “because he's the most friendly to entrepreneurs.” His company, Guy de Jean, makes most of its annual 150,000 umbrellas in France, despite its troubles with the labour laws. If Mr de Jean has a doubt about Mr Sarkozy, it is that he could “put everybody out on the street with strikes

if he tries to reform".

Back in the town hall, Mr Devin is hedging his bets. He might, he says mischievously, vote for Gérard Schivardi, the left-wing "mayors' candidate" and one of 12 who made it on to the official ballot this week. And, from his vantage point as France's electoral weathervane, who does the mayor think will win? Mr Devin does not skip a beat. "If I had to bet on a result, I'd say Sarkozy. He's the most prepared and the most structured, and his message goes down well in Donzy."

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Dangerous Russia

Fools and bad roads

Mar 22nd 2007 | MOSCOW
From The Economist print edition

Why are so many Russians meeting terrible deaths?

MORE than 100 people perished this week after an explosion at a Siberian mine. Thousands of kilometres away more than 60 died in a fire at a retirement home on the Sea of Azov. A few days earlier a plane crash killed six Russians in the southern city of Samara. Caucasian shoot-outs accounted for several more.

Russia is a paradoxical place. On many measures life is improving. Yet, as this week's run of catastrophes shows, there is an undercurrent of appalling violence. Russia's death rate from industrial accidents is four times America's. A Russian official recently said that the country accounted for two-thirds of all fatalities on Europe's roads; relative to the number of cars on them, Russia's are the world's deadliest. Contract killings and racist murders are only the most visible contributors to a homicide rate that is 20 times western Europe's. Suicide is five times more popular than in Britain. Russia's cumulative rate of violent death is unprecedented; with AIDS, tuberculosis and other scourges, it is driving a unique demographic collapse.

Why? Part of the problem is clapped-out infrastructure. Soviet roads and buildings were not designed for human comfort or safety, and Russia's new wealth has scarcely touched them. The emergency services have also missed out: the fire engines took almost an hour to get to the retirement-home fire. Unusually, President Vladimir Putin this week offered public condolences, but the Kremlin's attitude to disasters is usually a mixture of callousness and timidity. Problems are avoided or denied for as long as possible, witch-hunts preferred to real change. Unpopular reforms that might help are shirked.

Part of the Soviet Union's human legacy is low regard for any rules not enforced with maximum prejudice—and a cadre of officials happy not to enforce them, for the right price. New plans for higher fines for motoring offences, such as driving on the pavement, are seen as a chance for higher bribes for the traffic police, rather than for saner driving. Corruption contributes to mortality more directly. A bunch of ex-officers were this week sentenced for forging special Kremlin licence plates, sold as a package with flashing blue lights that let drivers flout traffic rules. Trade in old and counterfeit aircraft parts is said to be rife.

Alcohol, often in the form of cleaning fluids and the like, lubricates the carnage. It also poisons more than 30,000 Russians each year, compared with a few hundred Americans. But behind the booze, and the uncertainty and despair of post-Soviet life, lies something deeper and older.

Although they seem a godless lot, many Russians subscribe to an old religious fatalism. How else—in this well-educated nation—to explain the universal scorn for seatbelts, the epidemic of poisonings during every mushroom-picking season or the amazing number of winter fishermen who die each year after falling through the ice? (More than 400, some drunk, were rescued from a floating slab off Sakhalin last month; some refused to go.) There is little pressure for better safety standards. “Life is dangerous,” a Siberian tour guide said recently, when asked if the extreme sports he recommended were risky. “No one has survived it yet.”

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Charlemagne

Existential dreaming

Mar 22nd 2007
From The Economist print edition

Peter Schrank

Pro-Europeans have two broad and incompatible views about the future of the European Union

ACCORDING to Hallmark cards, when you turn 50 you no longer have to worry about acceptance by the young and hip (hopeless); having children (too late); listening to what people say (too deaf); or getting up unassisted (too bad). Well, obviously such a card couldn't be right for the European Union.

This weekend, Europe's leaders gather in Berlin to write a 50th birthday greeting to mark the signing, on March 25th 1957, of the Treaty of Rome, the founding text of what became the European Union. Agreement has been hard. The French wanted something on minimum welfare standards. The Poles wanted a reference to God but not to a constitution. The Germans wanted the constitution but not God. There was even talk of two declarations—one by the original six, a second by the others.

Although rejected in favour of an anodyne text, this idea was significant. For behind the wrangling lies a growing divergence between two concepts of what the EU is for. One holds that Europe is a good thing merely for existing, and that the more Europe, the better. The other says that Europe is only good for what it can do; the EU is an instrument for specific policies and whether it is a net plus depends on whether the policies work.

The first, existential view goes back to the EU's roots. The founders thought European co-operation was good for its own sake, since it would prevent war. The high point of this thinking came in the 1980s and early 1990s when Helmut Kohl, Germany's chancellor, talked in unabashed terms about a United States of Europe, and the ex-communist countries applied to join the EU because it embodied their identity as Europeans. Such talk is heard less often now but its ideals are still in the treaty, which commits its members to the goal of “ever closer union”. And it informs the views of at least two countries still. The Belgian prime minister, Guy Verhofstadt, wrote a booklet in 2005 called “The United States of Europe”; Luxembourg's prime minister, Jean-Claude Juncker, thinks almost all EU projects should be seen as preparations for political union.

Yet it is the second, instrumentalist view that has recently been the dominant one. In response to declining public support, the president of the European Commission, José Manuel Barroso, has started talking of “a Europe of results”—meaning a series of policies designed to win back popularity on issues people care about: climate change, energy security, cross-border crime, immigration. All these are global in character. Small countries cannot deal with them alone. The EU justifies itself as the organisation that

gives Europeans a voice on the world stage.

In a way this approach, too, goes back to the founders. Jean Monnet thought the EU should grow through acts of technical co-operation that would slowly win public support. But the latest boost for the second view came from the club's expansion to 27 members, not many of which are keen on deeper political integration. In effect, the idea that there should be two Berlin declarations reflects the psychological gap that exists between the original six and most of the later arrivals.

One might not expect this difference to matter much now. Both schools of thought want more integration, so that they differ from Eurosceptics, who want less integration, as well as from much of European public opinion, which thinks the present degree of integration is about right. Both want “more Europe” in response to globalisation, differing from the British chancellor, Gordon Brown, who thinks that globalisation weakens the case for regional blocks such as the EU. The two schools rub along; Mr Barroso embodies an attempt to reconcile them. Although he espouses “a Europe of results”, he comes from a country (Portugal) that joined the EU largely to confirm its identity in the European mainstream after years of dictatorship.

Yet the differences between the two approaches to Europe are now having an effect. Most obviously, instrumentalists tend not to like grand existential projects—the constitution, a European army, the Europeanisation of national legal systems. But it is no less true that many existentialists do not support the policies that animate the instrumentalists—or at any rate not enough to make them work. Everyone blithely signed on to the EU's flagship emissions-trading scheme. But France and Germany then gave their industries so many permits to pollute that they undermined the entire scheme. For them, the scheme was just something else to haggle over. For instrumentalists, it carried the burden of the EU's very future.

In search of love

At a time when everybody worries about the EU's lack of popular support, the two groups are looking for legitimacy in different places. The second naturally focuses on things they hope will win public backing. Academics call this “output legitimacy”. The first group is more concerned with “input legitimacy”—the respect that people give to institutions (such as national parliaments) that they recognise as representative, even if they do not always like what they do. Existentialists want to change the EU's institutions through the constitution, whereas instrumentalists fear this cannot resolve the EU's crisis of legitimacy.

This column leans towards the instrumental approach. It offers a rationale for the union's future, whereas the existential concept is a product of unprecedented historical experience—the post-war reconstruction of Europe and the fall of the Berlin Wall. But in truth, neither strand of opinion is likely to vanish. The nature of the EU's tortuous decision-making makes that very notion inconceivable.

In the long run, the bigger question is whether the two approaches can somehow be made compatible. The risk is that undermining the instrumentalists' policies will stop the EU earning legitimacy through results. But without results, the focus of democratic hopes and support will always remain the nation-state, however many Berlin declarations are intoned.

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The budget

Gordon's last fling

Mar 22nd 2007
From The Economist print edition

The chancellor promises tax cuts but there will be a bill for them

Getty Images

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GORDON BROWN may have been at the Treasury for longer than anyone since William Gladstone, but few of his budgets have been memorable events. Mostly they have been as uninspiring as their dire titles, which got off to a bad start in 1997 when the chancellor of the exchequer proclaimed his mission to be “equipping Britain for our long-term future”. This week the indefatigable Mr Brown was apparently still hard at work, “building Britain's long-term future”. But on this occasion, unlike previous ones, the budget he delivered was a showstopper.

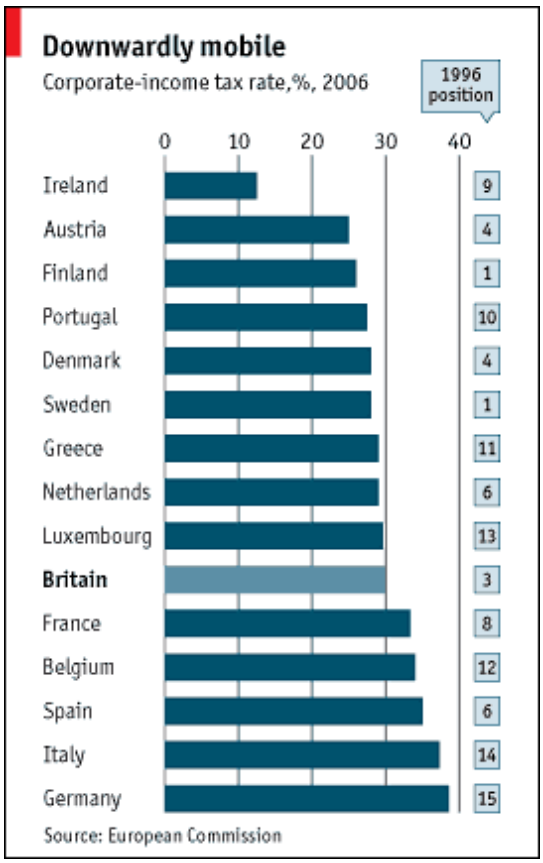
Mr Brown has long been considered virtually certain to take over from Tony Blair as prime minister. But the chancellor knows that a string of poor opinion polls and some barbed criticism this week by a former top civil servant of his “Stalinist” methods at the Treasury (see article) have undermined the morale of party colleagues and reawakened fears about his style of leadership. His budget—and unusually convivial style in presenting it—was above all an attempt to lift spirits and show that he was the man to win Labour a record fourth term in office.

Though Mr Brown's move to Number 10 Downing Street this summer is all but assured, he wants to convince the Labour Party that he has the popular touch. In particular he needs to regain the trust of two constituencies which have become increasingly alienated since Labour won its third term in 2005.

First and most important, ordinary voters have grown less grateful for the long period of sustained economic growth over which Mr Brown has presided. Small wonder, since household budgets have been squeezed recently by higher inflation and rising taxes. During Labour's first five years in office real disposable income per person increased by 3% a year, faster than in the previous two decades. Since 2001, however, it has been rising by only 1.5% a year, and most recently by less than 1%. On the eve of the budget, official statisticians revealed that retail prices, the broadest measure of inflation, increased in the year to February by 4.6%, the highest rate since August 1991 and ahead of average earnings, which have been growing by 4.2%.

Businesses constitute the second group that needs wooing. Businessmen have become increasingly disgruntled by Mr Brown's tax-grabbing ways, especially since his budget in 2002

pushed up employers' national-insurance contributions. Firms may not have votes but their bosses' disenchantment undermines Labour's crucial claim to combine social justice with a business-friendly regime. Furthermore, companies can vote with their feet, and more are threatening to move to countries with greater tax appeal. In 1996 Britain had the third-lowest corporate-income tax rate among the old 15 member states of the European Union; by 2006 it had slipped to tenth-lowest (see chart).



The political reasons for seeking to satisfy these two constituencies were clear but Mr Brown appeared boxed in by his previous extravagance. After an early period of austerity when he made much of his caution, Mr Brown turned into a big spender, proclaiming in 2000 that he had been “prudent for a purpose”. The resulting surge in spending, together with a run of disappointing tax revenues, sent the budget deep into the red (see chart below). The deterioration in the structural budget balance between 2000 and 2006 was the largest among big advanced economies, according to the OECD.

Since 2005 Mr Brown has sought to staunch the red ink through tax-raising measures and tighter control of spending. Tax changes between the election and the budget on March 21st will raise £6 billion ($11.8 billion) in the financial year that starts next month. And spending growth is to be reined in so that expenditure slides from 42.6% of GDP in 2007-08 to 42.0% in 2010-11. That retrenchment is worth £8 billion in today's money, according to the Institute for Fiscal Studies (IFS), a think-tank. Even so, the Treasury is now expecting the budget deficit to be a bit bigger over the years ahead than it did in December.

The backdrop could hardly have looked less promising for a tax-slashing budget. But that would be to reckon without Mr Brown's determination to cast off his image as a dour tax-raiser and the Treasury's ingenuity in making his sums add up. The chancellor astonished the House of Commons with not just one but two unexpected moves. First, the main corporation-tax rate, which has been held at 30% since 1999, will be lowered in 2008 to 28%. Second, and even more startling, the basic rate of personal-income tax will be cut at the same time from 22% to 20%.

Long experience suggested, however, that Mr Brown's headline announcements are not always all that they seem. So it proved on closer inspection of the Treasury's figures. Businesses will certainly gain from the drop in their tax rate, by £1.4 billion in 2008-09, rising to £2.2 billion in 2009-10. Stingier capital allowances, however, will raise the amount of profit subject to the tax, so the overall effect on companies will be neutral. Small firms are unhappy with other measures. Richard Lambert, director-general of the CBI, a business lobbying group, gave the proposals no more than a muted welcome.

Those who pay tax on personal income will also find that what Mr Brown has given with one hand he has taken away with the other. The gain to taxpayers from the cut in the basic rate will be £8.1 billion in 2008-09 and £9.6 billion in 2009-10. But most of that will be paid for by the abolition of the 10% starting rate of income tax, which will raise £7.3 billion for the exchequer in 2008-09 and £8.6 billion the following year. Mr Brown will also gain from changes he is making to national insurance, aligning the income levels subject to it with those in the income-tax system.

The measures will create personal tax losers as well as winners: according to the IFS, around one-fifth of families will be worse off as a result. One overall benefit will be tax simplification. Yet, ironically, it was Mr Brown himself who complicated matters in 1999 by introducing the 10% starting rate of income tax, thus fulfilling one of Labour's main pledges in the 1997 election campaign.

The chancellor can probably live with charges of inconsistency. But his decision to reinvent himself as a tax-cutter is unlikely to prove convincing as long as the overall tax burden remains so high. Ten years on, Mr Brown has left it too late to shrug off a record of overspending, overtaxing and overborrowing. That record will continue to haunt him if he becomes the next prime minister.

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Subprime mortgages

When the tide goes out

Mar 22nd 2007
From The Economist print edition

Rising house prices have hidden a multitude of sins

Get article background

IT SHOULD have been a warning sign to Britain's mortgage lenders, but news of the meltdown in America's subprime market (see article) has prompted only self-congratulation. With straight faces, lenders, rating agencies and investors have counted the reasons why mortgage lending in Britain is as neat and orderly as the terraced Victorian houses it often finances.

One sign of confidence was the bond sale last week by Kensington Group, a British mortgage lender, to people with dubious credit records. While New Century, America's second-biggest such mortgage lender, was shuttering its offices as clients defaulted on their loans, in Britain investors queued to throw cash at Kensington. Bond buyers wanted twice as much as the £800m-worth ($1.5 billion) of mortgage-backed bonds on offer and blithely accepted a lower rate of interest than they had demanded on similar bonds sold by the firm last June.

At first glance, such enthusiasm for subprime lending in Britain (where it is tastefully called “non-conforming” or “adverse-credit” lending) looks justifiable. This is a profitable market that has grown from about 6% of all new mortgage lending in 2005 to as much as 10% last year (though estimates differ). Interest rates on such loans are usually at least 50% higher than those charged to lenders' best customers. Bond buyers in turn receive yields about 0.2 percentage higher than those on Treasury debt.

Despite these rewards, zeal for subprime lending ought, surely, to be tempered by prudence. It is not, because the boom in British house prices has helped drive repossessions to unusually low levels. Even feckless homeowners have made paper gains on their homes and are thus more inclined to pay off their mortgages than to walk away from them. When they have been unable to keep up with their payments, banks have often convinced them to sell their homes, thus avoiding seizure. Kensington Group, for instance, says that although 9% of its loans were more than three months in arrears last year—slightly less than a year earlier—it had to write off only 0.7% of them.

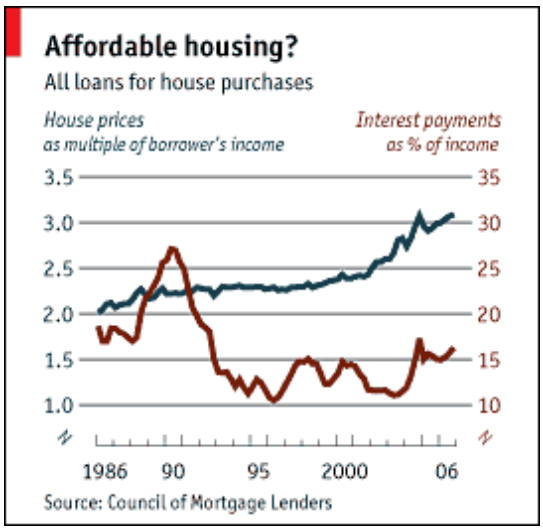
Emboldened mainstream lenders, too, are extending mortgages on looser terms these days. Around 8% of new home loans are “self-certified”—ie, borrowers do not have to prove what their income is—compared with 6% of all existing mortgages.

Increasing even faster are interest-only mortgages, which make up almost a third of the total issued to first-time buyers. They are not automatically cause for concern, especially if borrowers have made other plans to repay the capital. But a recent study by the Financial Services Authority, Britain's financial regulator, makes for worrying reading. It suggests that these loans are gaining popularity because people entering the housing market are ever more financially stretched (see chart).

About a fifth of interest-only mortgage borrowers said they could not have afforded to repay both capital and interest. Nearly a third said they would struggle to meet all their obligations if interest rates went up by a percentage point. And according to a study for the Council of Mortgage Lenders (CML), a trade body, last year, those taking out interest-only mortgages are more likely to be borrowing over 90% of the value of their homes and to have poor credit records than those signing conventional capital-repayment mortgages.

Buy-to-let mortgages are another fast-growing sort of lending

that raises eyebrows. These account now for about a tenth of new mortgages. But house prices have climbed faster than rents, so new buyers pay more to service their mortgages than they receive in rental income. As long as prices keep rising landlords can hope for profits in the form of capital gains, and those who run into cash-flow problems can usually sell their way out of trouble. But what happens if the music stops?



Michael Saunders, an economist at Citigroup, a bank, says that taken together these riskier lending practices are cause for worry. Repossessions, though still low by historical standards, rose by 65% in 2006. And many Britons carry a heavy burden of consumer debt as well as their mortgages.

Lenders and rating agencies are heartened by their models, which show that it would take a combination of higher interest rates and falling house prices to make a worrying number of mortgage loans go bad. But this is the exact confluence of events that is causing such woe in America. A little less complacency and a little more prudence are in order.

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Pub closures

Time, gentlemen

Mar 22nd 2007
From The Economist print edition

Posh London is shedding neighbourhood pubs. A pity

TRY squeezing into a City of London pub on a busy night and the idea that bankers pose a threat to historic drinking holes will seem far-fetched. But ancient pubs are vanishing from some of the smartest parts of London at unprecedented rates. The torrent of new wealth sloshing round the capital bears much of the blame.

Central London likes to think of itself as a collection of old villages. Districts such as Belgravia, Chelsea or Mayfair are dominated by quiet rows of low houses with back gardens, leafy squares and lanes lined with what were once artisans' cottages or stables. One sign of that village heritage is the public houses, some very old, that are still tucked away among what have become very expensive streets.

All across Britain pubs are closing, but they are under particular pressure in London's dearest bits. Pubs there are usually worth about ten or 12 times their annual earnings before tax. A smart London pub might earn £100,000 ($196,000) a year, making it worth a shade over £1m as a pub. But nowadays the houses that flank it may well be worth £3m, offering a quick fortune to anyone who can convert the pub to residential use.

Unsurprisingly, there are calls for intervention to help pubs survive. Some come from the aristocratic estates that still own hefty chunks of central London. The Cadogan estate (prop. the Earl Cadogan and family) has been unable in recent years to save a string of historic Chelsea pubs, some dating back to Tudor times. A number have become houses; others have been turned into “gastro-pubs” indistinguishable from restaurants.

Stuart Corbyn, the estate's chief executive, cites a recent closure, that of The Australian in Milner Street. It was a popular pub in the 1960s, when sleepy Chelsea became the party haunt of toffs and rock stars, but it fell into a sad, slow decline. A property developer bought and swiftly re-sold it for use as an interior designer's showroom, with two apartments above.

The local council, the Royal Borough of Kensington and Chelsea, has no specific policy of preserving pubs (though next-door Westminster does). What is more, residents are increasingly fussy about having even the tidiest pub as a neighbour. The Australian, typically, had been barred from allowing drinking outside for some years. Late licences, after 11pm, are also almost unknown in smart residential areas. Residents squelched a bid by a local historical group, the Chelsea Society, to speak up for The Australian.

David Le Lay, the society's chairman, wonders how raffish village charms will survive without a certain tolerance from residents. “If we don't watch out, we'll all be living in a very prim and proper area.” A survey by his society found that in the late 1950s there were 54 pubs in the old borough of Chelsea. In 1980 there were 44 and by 2005 the total was only 26; three more have closed since then, though some may re-open. With pubs shutting up shop, some streets are empty and echoing at night; and one of the rare places where people from different walks of life congregate socially is in shorter supply.

Fans of paternalism in Chelsea look longingly at a neighbouring landlord, Grosvenor (prop. the Duke of Westminster and family), whose Mayfair and Belgravia estates have not lost a single pub in five years. Grosvenor does not grant freeholds on commercial properties. The estate is swift to buy leases back if a pub is struggling, and to find new operators.

Not everyone craves more meddling in the market. Fuller, Smith & Turner, a London-based brewer, runs two of Belgravia's best pubs. Simon Emeny, its head of pub operations, praises the “long-term” view taken by Grosvenor, but insists his ventures in Belgravia stand on their own two feet as retail businesses. The grandest neighbourhoods will support pubs if you get them right, he says. That means good food and

wine, as well as good beer. If there are fewer pubs, he says, “that is capitalism at work. Those who are in the business for the long term will prosper.”

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Water in London

My sewer runneth over

Mar 22nd 2007
From The Economist print edition

The capital's overflowing drains are due for a big upgrade

Graeme Robertson

LONDONERS love to grumble, and one of their favourite topics is the inadequacy of their city's infrastructure. Narrow streets from before the car came of age make driving a nightmare. Much of the city's clunky, unreliable Underground was built in the reign of Queen Victoria, and it shows. Less noticed, but equally unsuited to the demands of modern life, is London's sewer system.

Built after a string of cholera epidemics in the 19th century by Joseph Bazalgette, an engineer in the heroic Victorian mould, the capital's 14,000-mile sewer network was a triumph of engineering and a victory for public health. But 150 years of urban growth have left the system unable to cope. Heavy rain can overwhelm the drains, forcing Thames Water, the firm that runs the network, to discharge a mix of rainwater and sewage directly into the Thames. Last year 32m cubic metres of diluted sewage were dumped into the river, at a rate of roughly one discharge a week.

On March 22nd the government revealed its solution: a £2 billion, 20-mile overflow and storage tunnel beneath the river, running from Hammersmith in the west to Crossness in the south-east—the biggest upgrade since Bazalgette's day. The decision is welcome news for environmentalists, who worry that overflowing sewers are damaging a river that had been recovering from the ravages of human activity. The Thames has been polluted for centuries: in 1383 Parliament taxed households whose latrines emptied into the river's tributaries. The industrial revolution was the knockout blow, and by 1858 the smell was so bad that MPs were forced to hang lime-soaked sheets over the windows of the House of Commons. By the middle of the 20th century the river was almost devoid of life.

Since then environmental regulation and industrial decline have rejuvenated the Thames. Salmon—a notoriously fussy species—were reintroduced in the 1980s. Today the river hosts over 100 sorts of fish, as well as seals, dolphins and seahorses. But big sewage overflows can wreak havoc. In June 2004, for example, tens of thousands of fish perished after a bout of heavy rain. Rotting fish look and smell awful, and the dirty water poses a human health risk as well.

Not everyone is happy with the government's plans. Ofwat, the industry regulator, worries that the super-sewer may be too expensive and that the money would be better spent on improving sewage treatment. Others point to the government's dismal record of cost overruns and late delivery on big engineering projects. But the same problems dogged Bazalgette's sewers 150 years ago. With the benefit of hindsight, they now look like quite a bargain.

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Legal-aid reforms

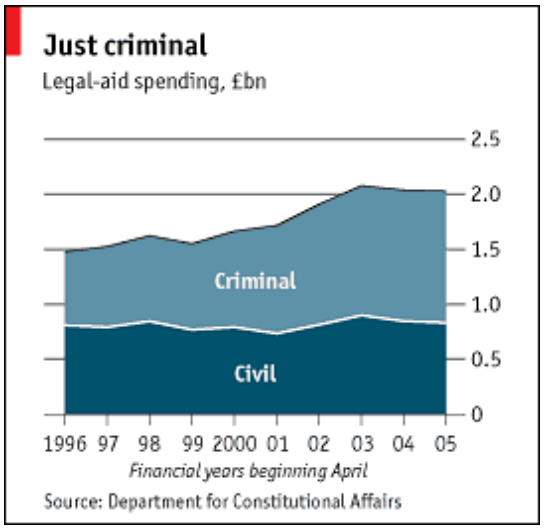
Unwise counsel

Mar 22nd 2007
From The Economist print edition

The government has misdiagnosed a problem—and its solution

“MORE money for lawyers!” was never likely to be a popular rallying cry. Sure enough, a demonstration by hundreds of solicitors on March 19th in London failed to win the sympathy that nurses or firemen get. “Unprofessional and irresponsible,” sniffed the government. Clients stranded in court by a three-day work-to-rule protest probably agreed.

The unlawyerly banner-waving was provoked by government plans to tinker with legal aid, the free or subsidised advice and advocacy that is nearly always offered to those on low incomes and to others in certain circumstances. The goal is to control the cost of legal aid, which, at £2 billion a year in England and Wales, is the highest per person in the world and 37% bigger than it was a decade ago (see chart).



A belt-tightening report from Lord Carter, a businessman asked by the government to look into the matter, suggested last July that it would be possible to economise on procurement. Solicitors currently earn an hourly rate; from next month the government will instead pay a flat fee per case, rewarding those who work quickly and penalising dawdlers. From October firms will have to bid against each other for contracts to provide legal aid in their neighbourhood. Ministers hope market forces will make small practices merge, encourage specialisation and drive down prices.

This has not gone down well with lawyers or their clients. The Law Society, which represents the profession, pointed out that thousands of small high-street firms were already hard-pressed after a ten-year freeze on legal-aid rates. (These concerns were mirrored in an independent report commissioned by the government, which warned that many criminal solicitors were already “highly fragile” financially and the reforms were too precipitate. Ministers sat on these findings for four months, releasing them only this month.) Many doubt whether most firms will have enough capital—and optimism— to restructure as the government hopes.

Fixed fees, while reasonable in principle, may drive down quality. Liberty, a human-rights outfit, fears that firms will improve their “efficiency” by ditching clients who cannot speak English, or have mental-health or other awkward problems. A recent study of the Scottish system, which moved to fixed payments for criminal legal aid in 1999, made the disturbing finding that solicitors changed their pleading practices when they were no longer paid by the hour. Pleading guilty shortly before trial “may represent the optimal economic management of fixed fees”, it explained.

Most perplexing is the idea that the rise in legal-aid spending is all down to lawyers' inefficiency. The growing bill has coincided with a slew of criminal-justice measures that have increased the volume and complexity of cases. Family breakdown has kept the civil courts busy, and new technology—from CCTV to forensic science—has turned formerly simple (or non-existent) trials into epics. It is hardly surprising the bill has gone up.

Depressingly, even its architects expect the overhaul to save just £100m—less than 5% of last year's total bill. And it comes just as costs show some sign of stabilising, and changes to means-testing last October may cut another £35m a year. Anyway, it seems that legal aid is money well spent. A report in 2005 estimated that 1m problems a year go unsolved because people cannot find advice, costing society up to

£4 billion. Its authors? The same government that now says £2 billion is too much.

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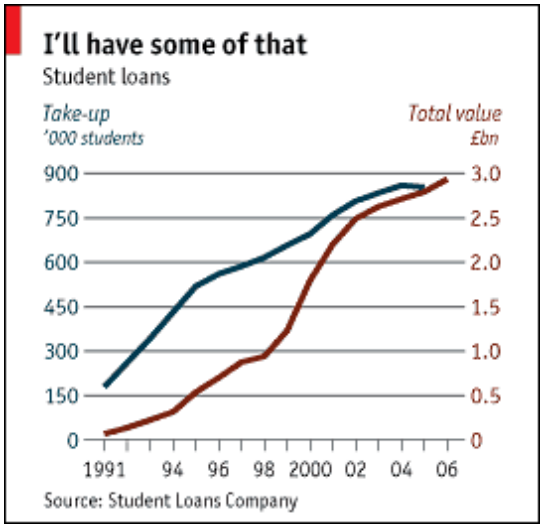
Student debt

The price of knowledge

Mar 22nd 2007
From The Economist print edition

How not to get more poor students into university



WHEN the chancellor, Gordon Brown, was a history undergraduate in the late 1960s, only one in seven of his contemporaries went to university. Now three times as many do, and the result has been a funding squeeze. By 2005 teaching an undergraduate earned a university just £6,000 a year in student fees and government contributions—in real terms, only half what they got in Mr Brown's day.

Things started to look up in 2006. English universities were, for the first time, allowed to set their own fees, though confined by a cap of £3,000 a year. The welcome result was a 30% rise in the amount they receive for teaching. Students can borrow the fees from the government, as well as a sum towards living expenses. The poorest get grants to cover their fees.

Now student debt is to be privatised so that the government can spend on education today what would otherwise have had to wait until borrowers repaid their loans. In his budget speech on March 21st, Mr Brown announced he would be selling off £6 billion of the £19 billion of debt owned by the Student Loans Company, a subsidiary of the education department that currently lends around £3 billion a year (see chart). Mooted buyers include pension funds and high-street banks.

The sale is likely to raise far less than the face value of the debt, though, because the government is a generous lender. Once a graduate starts earning, he need repay only 9% a year of his income over £15,000. Interest is never more than inflation, and anything unpaid after 25 years is written off. Students are likely to repay only half of what it cost to lend them the money.

The cash raised by selling the government's student-loan portfolio will help pay for more individual teaching in state schools: by 2010, said the chancellor, 600,000 pupils will be receiving one-to-one tuition. In a separate speech, the head of the government's exams watchdog said that the broad-brush and formulaic national tests now taken by all state-school students at the ages of seven, 11 and 14 are likely in future to be sat by a random sample of them—enough to monitor school standards. The focus would switch to more individual diagnostic testing so that teachers could tailor their lessons accordingly.

Mr Brown could have more to spend on schools if he charged a realistic interest rate on university loans. It was set as low as it was to woo opponents of higher university fees, who feared they would put off poor students. But the subsidised rate is regressive. Better-off students can borrow money they don't need to study, park it in a high-interest savings account and comfortably repay the loan after graduation.

Worse, because they are so expensive for the government, loans are heavily rationed. The limit on borrowing for living expenses is set far too low, pushing poor students towards pricey consumer debt to make ends meet. Part-time students and those at further-education colleges, who tend to be from poorer backgrounds, are not eligible for the loans.

On March 15th the government revealed a new scheme for getting more young people from poor homes into higher education. The central university-admissions body, UCAS, said that it would start asking applicants whether their parents had gone to university. Universities would be free to pass students' answers to admissions officers with their applications, along with information about their social class and ethnicity. On March 20th it emerged that data about the exam performance of other students from the

same school might be provided too.

The evidence, though, is that the real stumbling block for poor would-be undergraduates comes much earlier. With the same exam results they are as likely to apply, and to be accepted, at university as the well-off are. It is getting those results in the first place that is the problem. Charging realistic fees and higher interest on loans would make more money available to tackle the root cause of their exclusion.

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Bagehot

Can Gordon do glasnost?

Mar 22nd 2007
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"Stalinist ruthlessness" is the last thing Gordon Brown wants to be known for. It's up to him whether he is

Steve OBrien

AS GORDON BROWN reminded us on March 21st with what is certain to be his last budget, he is a formidable political operator. He is an equally formidable hater. No slight or insult is ever forgotten or forgiven. Once an enemy, always an enemy. To the long list of people who have given the chancellor offence, the name of Andrew Turnbull can now be added.

Lord Turnbull, who was Britain's top civil servant until two years ago and permanent secretary at the Treasury under Mr Brown for four years before that, is an unusual addition to the list. Most are ministers who crossed the chancellor in some way, by showing either too much independence from the Treasury or too much loyalty to the prime minister. Some are political advisers such as Derek Scott, Tony Blair's former economic adviser, and Jonathan Powell, his chief of staff: a special place in Brownian hell is reserved for senior courtiers at Number 10.

According to those in a position to know, Mr Brown has not spoken to Mr Powell since soon after Mr Blair became leader of the Labour Party in 1994, even though he is forced to pass his desk every time he visits the prime minister. Mr Powell's transgression was to laugh when Mr Brown suggested that some of the money he was raising to run the new leader's private office should be handed over to the shadow chancellor.

For his part, Lord Turnbull, in what may or may not have been an unguarded moment, made some searing criticisms this week to the *Financial Times* about the way Mr Brown conducts himself in government. The retired mandarin accused the prime minister-in-waiting of being a ruthless "Stalinist" who treated other ministers with "more or less complete contempt" and had "a very cynical view of mankind and his colleagues".

Lord Turnbull reportedly went on to say: "He cannot allow them any serious discussion about priorities. His view is that it is just not worth it and 'they will get what I decide'. And that is a very insulting process." Mr Brown's reliance on commissioning "celebrity reviews", such as the report by Sir Derek Wanless on the future of the National Health Service, had, Lord Turnbull believed, been "an unworthy

development in the sense that it belittles other ministers". He also attacked Mr Brown for a tendency to go missing at times of difficulty.

There was nothing very revelatory in Lord Turnbull's remarks. The hurts and frustrations of Mr Brown's colleagues have been widely reported. Former ministers have been increasingly willing to go public about what working with Mr Brown is like—most devastatingly the former home secretary, Charles Clarke, last September.

What is surprising is the source, the timing and the ferocity of the attack. Although a top civil servant, Lord Turnbull always eschewed the silky circumlocutions supposedly preferred by his ilk in favour of plain speaking. But he disapproved strongly of the disparaging comments about ministers in a book by a former Washington ambassador, Sir Christopher Meyer. So what prompted his outburst?

As cabinet secretary, Lord Turnbull was a strong proponent (and partial architect) of Mr Blair's attempts to use choice and multiple providers to bring about self-sustaining improvements in public services. Mr Brown's Treasury, confident of its target-based approach, was sceptical about this strategy. Believing the civil service has to become far better at "delivery", Lord Turnbull now regrets the tensions within the government that undermined wholehearted implementation of policies he backed.

As for the timing, Lord Turnbull insists that he had not expected to be quoted so extensively. Yet it is reasonable to assume that such an experienced player must have intended his remarks to have maximum impact at a moment when Mr Brown's succession is both imminent and apparently unstoppable.

A more interesting question is what Lord Turnbull's purpose was, if not simply to embarrass Mr Brown. It appears that a number of senior mandarins have become increasingly troubled by the thought that Mr Brown will import his relentlessly centralist management style from the Treasury to Number 10. They are critical of Mr Blair's slapdash "sofa" governing, but they are appalled by the consequences for good government if nearly every aspect of policy is decided by a tiny coterie of Brown loyalists from the Treasury. They seem to be hoping that, by bringing the problem to the surface in such a dramatic way, they will leave Mr Brown no choice but to address it.

Speak truth unto power

Fortunately, the current cabinet secretary, Sir Gus O'Donnell, who is known to share their concerns, has at least one foot in the Brown camp. He won acceptance there as a blokeish, football-loving can-doer during his time at the Treasury. Nobody is in a better position than Sir Gus to speak truth unto power by warning Mr Brown of the urgent need to change the way he conducts business before he takes over from Mr Blair.

Among the truths he must communicate is that prime ministers, who do not have the resources of a major department behind them, cannot command government as if from the bridge of a ship. Nor can a leader who has to deal with a dozen big things before lunch every day, some of them wholly unanticipated by his diary secretary, refuse to delegate to departmental colleagues and listen to their views. Debate within government is vital for good decision-making, but without the counterweight of one half of the old Blair-Brown axis there is a real danger that there will be no arguments hereafter.

If Mr Brown is wise, he will swallow his anger with Lord Turnbull and heed his important criticism. Mr Brown understands that restoring trust in government is perhaps the most important and most difficult task he faces. But does he even begin to understand how to do it?

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Apology: scrambled Britain section

Mar 22nd 2007
From The Economist print edition

An apology to those who received a horribly scrambled Britain section in the March 10th issue. Faulty instructions to a computer were to blame.

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Amnesty International

Many rights, some wrong

Mar 22nd 2007
From The Economist print edition

David Simonds

The world's biggest human-rights organisation stretches its brand

AMNESTY INTERNATIONAL is the biggest human-rights organisation in the world, with 70 national chapters and 1.8m-plus members. Its battle honours glitter. It has defended moral giants among prisoners of conscience such as Vaclav Havel and Andrei Sakharov.

Amnesty still champions such causes, rattling dictatorial governments (and governments with dictatorial tendencies). But its mission has also become broader and more ambitious, calling for political and economic improvement as well as freedom from judicial persecution. “Working on individuals is important, but if we don't work on systemic change we just exchange one group of sufferers for another,” says Irene Khan, its secretary-general.

Many of the movement's most vocal supporters strongly support this stance, increasingly entrenched in Amnesty's thinking; it also chimes well with the visceral opposition to American foreign policy, and to globalisation, that exists in many parts of the world. All that has made Amnesty more popular in some quarters—but also, perhaps, less effective overall.

Amnesty's website—admittedly not the same as the organisation, but still a shop window for its main concerns—can certainly be disconcerting for those who have not followed the changes of past years. Instead of named individuals locked up by their governments, it highlights a dozen campaigns. Top comes “stop violence against women”, including discrimination by the “state, the community and the family”. The second asserts: “The arms trade is out of control. Worldwide arms are fuelling conflict, poverty, and human rights abuses.” The third—closer to a traditional Amnesty campaign—is “stop torture”; this focuses mainly on abuses in the “war on terror”, and links to a campaign to close the prison camp in Guantánamo Bay.

Ms Khan infuriated both the American government and some Amnesty supporters in 2005 when she described Guantánamo as the “gulag of our times”. She stands by her statement: like the gulag, Guantánamo “puts people outside the rule of law”, she says. Yet the comparison seems odd in scale and in principle: the gulag embodied the Soviet system; Guantánamo is a blot on the American one.

Not that old-style Amnesty was soft on the West. Using the moral authority it had won by confronting

both apartheid and communism, it challenged Western governments whenever they seemed to be cutting legal corners; in that spirit, it opposed Britain's policy of internment in Northern Ireland.

But these days America does seem to have a strangely high priority, given the enormity of human-rights scandals elsewhere. One of the four “worldwide appeals” launched in March urges the public to press the American government to grant visas to the wives of two Cubans jailed for acting as “unregistered agents of a foreign power” (in effect, spying). Zimbabwe, scene of bloody repression in past weeks, comes fourth—but the appeal deals not with current events but with the persecution of a movement called “Women of Zimbabwe Arise”, an admirable but narrower cause.

Another of Amnesty's 12 campaigns is on “Poverty and Human Rights” which asserts: “Everyone, everywhere has the right to live with dignity. That means that no one should be denied their rights to adequate housing, food, water and sanitation, and to education and health care.” A similar theme is struck by the “Economic Globalisation and Human Rights” campaign—reflecting Amnesty's enthusiastic support for the World Social Forum, a movement which holds annual anti-capitalism shindigs. Sometimes there seems to be a desire to be even-handed between pariahs and paragons: Amnesty recently surprised observers of the ex-communist world by producing a critique of the language law in Estonia—a country usually seen as the best example of good government in the region.

The big question in all this is priorities. Cases do exist where violations of political rights and of economic ones are hard to separate; one such case is Zimbabwe, whose government has engaged in politicised food distribution and slum clearance at the same time as judicial repression.

But the new Amnesty is surely open to the charges both that it is campaigning on too many fronts, and that the latest focus comes at the cost of the old one.

Amnesty's website is, insiders acknowledge, a campaigning tool; it does not fully reflect the depth of the organisation's expertise, or its internal priorities. Ms Khan admits a tension in the organisation's “business mix” between high profile and less immediately rewarding work.

But she insists that there is no drift towards America-bashing for the sake of popularity, and that the emphasis on economic, social and cultural rights does not reflect a preference for any particular system of government.

Perhaps unavoidably, the stance taken by Amnesty's increasingly autonomous national chapters in the domestic affairs of their countries is decidedly political. In Colombia, for example, the movement opposes a law that offers reduced sentences to right-wing paramilitaries but made no objections to past proposals for amnesties for left-wing guerrillas.

Amnesty may to some extent be the captive of its need to keep a mass membership enthused with new and compelling causes, even at the cost of narrowing its appeal to those with unfashionably positive views about America or global capitalism. Its expert researchers and analysts still continue in their work, but sometimes feel let down by what the leadership chooses to showcase. Amnesty has to compete for attention and funds with other human-rights organisations: its “unique selling proposition”, says Ms Khan, is that it gives ordinary people a chance to participate. Yet the best means of ensuring that—writing letters to, and about, prisoners of conscience—has shrunk.

The collapse of the Soviet empire and of apartheid rule in South Africa cut the number of visible prisoners of conscience. Countless tens of thousands may languish in China's *laogai* forced labour camps (a system that truly deserves to be called a gulag), and many are incarcerated in places such as North Korea and Myanmar (Burma). But even getting the names of the inmates is hard, let alone embarrassing the governments. Writing letters on behalf of a Havel or Sakharov sparks members' enthusiasm far more than a few blurred pictures of a remote camp with anonymous inmates.

Amnesty's American-based counterpart, Human Rights Watch, has also changed its emphasis, but less controversially. It keeps classic human-rights questions at the centre of its activities and gives only modest attention to other concerns. On weapons, for example, it campaigns to limit the use of cluster bombs, but not against the arms trade in general. It sticks to situations where its fastidious, legalistic approach will work, “namely, the ability to identify a rights violation, a violator, and a remedy to address the violation.” That covers arbitrary government conduct that leads to a violation of economic rights (such as the right to emigrate), but steers clear of general hand-wringing about poverty or poor public services.

Current and former Amnesty insiders worry that an increasingly grandstanding and unfocused approach makes it ineffective. Sigrid Rausing, a top British donor to human-rights causes, says she regrets the “blurring” of the original mission: “There are so few organisations that focus on individual prisoners of conscience.” Her husband, Eric Abraham, was supported by Amnesty while under a five-year sentence of house arrest in South Africa in 1976.

Some wonder if Ms Khan has been too keen to impress constituencies in what NGO-niks call the “global south”: code for developing countries, where opinion—at least among the elite—supposedly favours economic development over a “northern” concern for individual rights. She vigorously contests that. But an organisation which devotes more pages in its annual report to human-rights abuses in Britain and America than those in Belarus and Saudi Arabia cannot expect to escape doubters' scrutiny.

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Human Rights and the UN

Great expectations

Mar 22nd 2007 | NEW YORK
From The Economist print edition

Hopes fade for a fairer UN policy on human rights

A LOT of optimism attended the birth of the UN Human Rights Council, created last year by a 170-4 vote of the General Assembly. Whereas the United States kept on the sidelines (and confirmed this month it would stay away), many Western states saw the new body as an improvement on the discredited Human Rights Commission it replaced.

But now some of the commission's critics are fretting that the Geneva-based council may prove only a little better, or perhaps even worse, than its predecessor. What they are watching keenly is the council's reaction to the massacres and humanitarian disaster in Darfur.

This month the council received a report on Darfur which did at least spell out some basic facts. It said the Sudanese government has aided *janjaweed* militias, “including in violations of human rights”. The council's investigators had to glean this from refugees in Chad and elsewhere, as they were denied visas to visit Sudan. But the UN investigation managed to bring certain harsh truths to light: at least 200,000 are dead (many think the number is double that), the situation is getting worse not better, and the government is largely to blame.

Sadly, though, the full council is unlikely to draw the logical conclusion and hold Sudan's rulers to account. That is partly because Muslim countries, along with various non-democracies with a soft spot for tyrants, hold a majority of the council's 47 seats; between them they are shielding the Khartoum regime.

More surprisingly, countries such as South Africa and India are siding with Sudan. The best that can be expected is a weak EU-sponsored resolution that vows to monitor events and urges all parties to do their bit. That would leave Israel the only state to have been condemned by the council—eight times.

This sort of imbalance is all too reminiscent of the old commission. One much-vaunted improvement was a new universal-review system—under which every country's record would be scrutinised from time to time. This would at least force human-rights abusers to answer some hard questions.

But it now looks clear that any follow-up to these inquiries will be feeble; and a group led by the Cubans wants to use the universal review as an excuse to get rid of the special rapporteurs who keep an eye on places such as Belarus, North Korea—and Cuba.

At best, the council is a declamatory body; real power lies with the Security Council in New York. But the mess in the UN's top human-rights agency augurs ill for the reform of the UN as a whole.

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Psychiatry and films

Great plot, shame about the characters

Mar 22nd 2007
From The Economist print edition

Using film to train shrinks works better in some places than in others

Rex

For some, Jack Nicholson is totally as good as it gets

EVERY culture has its own ideas about health, privacy and medicine. But in most places people can agree there is nothing too mysterious or controversial about the science of broken bones—or the way aspiring doctors should be taught to mend them. As every medical professor knows, you just find a patient with some nice fractures and escort a gaggle of students to the bedside for a good long stare. As long as the sufferer is not prodded too hard, or denied a clear view of television, no ethical rules are violated.

But things are much more delicate when it comes to teaching pupils about psychiatric disorders—not least because the very definition of mental illness is controversial and varies from culture to culture. Then there are the ethical and legal questions: if patients' mental symptoms are severe, it might be harmful to subject them to student questioning. Even videotaped interviews with consenting patients have drawbacks. Show the tapes to enough students, and someone might recognise a neighbour or family friend.

In the United States, a growing number of psychiatry professors see an answer in Hollywood and its large output of films that deal with disorders of the mind. Carol Bernstein, a teacher of psychiatry at New York University School of Medicine, has found a good response to a course she co-presents called: “Teaching Psychiatry? Let Hollywood Help!”

Its popularity seems to disprove the charge that Hollywood “trivialises” mental disorders, Dr Bernstein says. The course attracts doctors from all over North America, and increasingly from Europe—although many European psychiatrists have their doubts about teaching by film.

Roelof ten Doesschate, head of a large psychiatric hospital in the Dutch city of Deventer, worries that films like “As Good As It Gets”—a portrayal of an obsessive, cantankerous writer—understate the wretchedness of real-life mental illness. Dutch hospitals already use actors for training purposes, hiring them to play disruptive patients—so the idea of using simulation to teach medical students is not too shocking. But the American practice of using film clips to teach already qualified doctors, training to be specialists, does alarm Dr ten Doesschate; at that level, he feels, only flesh-and-blood patients will do. “For registrars it's a poor solution, they need to be doing real work.”

But Dr Bernstein sees teaching by film as both valid and necessary, especially for instruction about

personality disorders like paranoia, obsessive compulsive disorder or psychopathy. Sufferers from such disorders are hard to find. Psychopaths often shun psychiatrists, and, she notes: “A paranoid patient isn't going to consent to have a lot of people interviewing them.”

Her verdict on “As Good As It Gets”, which stars Jack Nicholson, is rather positive. Throughout the film, she argues, “you see how the disorder impairs his ability to function. Now, if you took a medical student into an interview with a patient, in 45 minutes you're not going to see that. Film gives them a sense of what life is like with that disorder.”

Dr Bernstein admits, though, that many film depictions of psychiatry and mental disorders are “terrible”. Among shrinks, there is keen resentment of the comedy “Me, Myself & Irene”, in which Jim Carrey plays a policeman variously described as “schizo”, “psycho” and suffering from multiple personality disorder. In contrast, the film “A Beautiful Mind”, about the mathematician John Nash, is praised as a fair depiction of schizophrenia.

Not that psychiatry on film is ever quite true to life. Much psychiatric medicine is undramatic stuff, involving the prescription of drugs to uncommunicative patients. Hollywood prefers to show sufferers talking about their problems. Glen Gabbard, director of the psychiatric clinic at Baylor College of Medicine in Texas, studied hundreds of fictional film psychiatrists to co-write the book “Psychiatry and the Cinema”. He found that “movie psychiatry bears almost no resemblance to real-life psychiatry. If we videotaped a typical day in my practice with patients, the audience would be bored out of their minds.”

Even in the old world, teaching by film has its advocates. Dinesh Bhugra, dean of the Royal College of Psychiatrists in Britain, has long supported the educational use not just of Hollywood films but also of Bollywood films from his native India. The professor, who began his training in India, is convinced that movies remain under-valued as teaching tools in both countries. “In Britain, cinema still has generally a low cultural value, and in India it is a snobbish thing to look down on Bollywood,” Dr Bhugra laments. Such arrogance is missing the point, he argues: whatever their artistic merits, Bollywood films are a useful way to teach medical and psychiatric students about “cultural issues to do with the family, or shame versus guilt”.

Indian films may not be as suitable as American ones for showing specific mental disorders. Having studied the way Hindi films treat mental illness, Dr Bhugra finds that too often psychoses are sketchily portrayed: they frequently involve people “hearing voices”. The mentally ill tend to be relegated to slapstick sub-plots, alongside a central love story.

Such stereotypes may be shocking to Western scientific sensibilities, but they can still—in Dr Bhugra's view—be a useful window on some aspects of Indian culture. It's the sort of insight a shrink might need in multicultural London.

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Executive salaries

The politics of pay

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From The Economist print edition

The rewards of America's company bosses face yet more scrutiny and attack

David Simonds

Get article background

NOW there is nowhere for the bosses of corporate America to hide their bulging pay packets. In spite of years of defensive lobbying, they are having to reveal all under new Securities and Exchange Commission (SEC) rules that have just begun to take effect. This burst of sunlight could not have come at a worse time for them. It coincides with a shift in the control of Congress to the Democrats and the start of the presidential election campaign, in which “overpaid” chief executives will make an easy target.

Although barely one-tenth of the 2,000 biggest American companies have yet reported under the new rules, the tally of negative headlines is already mounting. “There are already plenty of examples of firms reporting chief-executive pay packages of millions of dollars more than expected,” says Paul Hodgson of the Corporate Library, a research firm. He reckons that the firms that have already reported are a representative sample likely to provide a good indication of the overall trend. Top of the heap so far is Ken Lewis, boss of Bank of America, with total pay in 2006 valued at $114.4m.

One area of generosity is the chief executive's future pension. Another is “deferred pay”, whereby a top executive leaves some part of his salary in the hands of the firm, as a loan of sorts. GE recently reported that Robert Wright, until recently the boss of NBC Universal, its entertainment subsidiary, has accumulated deferred pay worth $40m, the highest so far. Quite why a boss or firm should want to resort to this tactic has never been clear, although the suspicion has always been that the firms are offering managers unusually good returns at the shareholders' expense. Now the details of these arrangements are being published for the first time, so it will become clear whether that was so.

In a study of 100 firms that have reported, Mr Hodgson found that the perks given to chief executives, though relatively small, were much higher than those reported last year under the old, less exacting, disclosure rules. On average, the amounts reported in 2006 under the heading “other annual compensation” in 2006 were $192,000—131% higher than in the corresponding category in 2005. One reason for this jump was that the new rules require the disclosure of all perks worth $10,000 or more, whereas the old rules allowed firms to keep quiet about anything worth less than $50,000.

Of particular interest will be the data on personal use of the corporate jet. This is expected to decline sharply as firms start to charge the boss for personal flights in order to avoid embarrassing headlines. No company wants a repeat of the battering suffered by Tyson Foods after revelations that “friends and family” of Donald Tyson, a former boss, made undisclosed use of the corporate jet—valued at over $1m—without his even being on board.

Another likely target is the golden parachute for a departing boss, especially if he has left because of poor performance. This is increasingly a focus of activist shareholders, including hedge funds. On March 20th John Antioco, the boss of Blockbuster, a video-rental firm, announced that he would resign by the end of the year. Following a long battle over his bonus with Carl Icahn, a legendary corporate raider, he agreed to accept much less in severance than he had said he was entitled to under his contract.

The directors' cut

Boards have already started to pay greater attention to how they set the chief executive's pay and to being seen to do so in a way that serves the interests of shareholders. One reason is the requirement that compensation committees consist entirely of independent directors, introduced as a listing requirement by the New York Stock Exchange in the wake of the corporate scandals at the start of the decade. These committees must now hire compensation consultants, and many are insisting that they do no other work for the company. Previously, compensation consultants typically had other lucrative contracts, which may have swayed their judgment.

The new climate surrounding pay has already had an effect. Base salary has stabilised, though it was never the fastest-growing part of pay. Options, which even before the recent backdating scandal were losing their appeal, have been partly replaced by performance-related pay.

“Boards are being tougher with new hires, in particular, as it is hard to get a sitting chief executive to give up pay promised in his contract, at least without compensation,” says Russell Miller of Korn Ferry, a recruitment firm. Even being tough on new chief executives is not proving easy, however. Boards know that the choice of a boss can have a huge impact on a firm's performance. Executive talent is valuable. Private equity is on the prowl, offering packages with incentives that a public company can find hard to match amid all the denunciation of fat cats. Those are good reasons to expect pay to continue to grow, in spite of the outrage.

Not everybody is happy with the quality of the disclosures made so far. One issue is the length and complexity of the statements, which often run to 30 pages or more of opaque legalese. There are also complaints that the single number for total pay required by the SEC is misleading. “There is more than one honest answer to the question, ‘How much did you pay the chief executive?'” says Joe Grundfest, a former SEC commissioner who is now at Stanford University. The SEC requires firms to combine both the actual pay bosses receive each year and an estimate of the value of future performance-related pay, such as share options, which is calculated using a formula known as Black-Scholes. But the value of such options changes along with the firm's share price—they could even prove to be worthless. “The one certainty is that the option grant will not turn out to be worth the Black-Scholes valuation,” says Mr Grundfest. Which is why the SEC should require two totals to be published, argues Ira Kay of Watson Wyatt, a compensation consultancy. As well as saying what managers might earn, they should estimate what they have earned. Unlike the SEC's number, such “total realised pay” correlates well with firms' performance, says Mr Kay.

Such subtleties may not matter much to the headline writers. Outraged politicians in Washington, DC, smell blood. Barney Frank, chairman of the House financial services committee, is proposing legislation to require companies to seek the (non-binding) approval of shareholders for executive pay packages each year.

There may also be moves to toughen the tax treatment of executive pay, perhaps by removing tax benefits for performance-related compensation, at least above a certain level, says David Yermack, an economist at New York University. Share options and pensions may also come under fire. Given the growing number of middle-class Americans who have to pay the higher alternative minimum tax, Congress may feel that heavier taxes for corporate bosses have populist appeal. “Anything is possible in this climate,” says Mr Yermack, “so bosses may need to get used to the idea that more of their compensation will be subject to taxation.” At least they can afford it.

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Travel firms

Double-booked

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TUI and First Choice merge

AS SOON as Michael Frenzel, chief executive of TUI, Europe's biggest travel firm, heard about the merger of two rivals, Thomas Cook and MyTravel, he reached for the telephone. He knew that both firms, Europe's second- and third-biggest respectively, had previously courted First Choice, the fourth in the rankings. Now it was his turn to call Peter Long, the boss of First Choice.

TravelLounge

Did they book through an agent?

Mr Frenzel was luckier than his rivals had been. On March 19th TUI, which is based in Hanover, announced that it would merge its travel business with First Choice. The deal will create TUI Travel, which will be listed on the London Stock Exchange and based in Britain, the home of First Choice. TUI will own 51% of the new firm and First Choice the rest. Mr Long will be the merged company's chief executive and Mr Frenzel will take over as chairman. The new group will have sales of €17.6 billion ($23.4 billion) a year and some 27m customers in 20 countries

As bullish as all this sounds, the merger stems from adversity. Europe's big tour companies have all struggled as travellers have turned to internet-based competitors, or have been lured into cobbling their own holidays together, starting with a cheap flight from a low-cost airline. TUI, the market leader, has come under more pressure than its peers have. The company's share price has fluctuated wildly because of speculation that it would be taken over itself and concern about its big debts and pension liabilities. Towards the end of last year its bosses concluded that radical action was needed. In mid-December they announced a painful restructuring programme involving 3,600 job cuts in Britain and Germany and some €110m of cost cuts in the back office.

Mr Frenzel is planning to go ahead with the restructuring programme despite the merger with First Choice. On the day of the announcement the TUI group reported a loss for 2006, mainly because of the cost of integrating a Canadian shipping company into Hapag Lloyd, TUI's logistics arm. The tourism business made a €400m profit last year and cost-cutting should ensure that profits are sustained. “Germany is booming,” says Mr Frenzel.

Investors welcomed the deal. “TUI is specialising in package tours while First Choice is big in special tours, so the two are a good fit,” says Martina Nass, a travel analyst at Germany's Norddeutsche Landesbank. According to Carmen Hummel, a credit analyst at Unicredit, an Italian-German bank, TUI is good at integrating the firms it takes over, whereas First Choice has worked out how to preserve profits despite the obstacles facing the business. First Choice's margins, at 5%, are almost double those of TUI—which is

what made the firm so attractive to all its suitors.

Mr Frenzel hopes that First Choice's expertise in adventure trips and other holidays with “special effects” will make the new TUI Travel more profitable. He also wants to make more of the firm's online offerings. Britons in particular have taken with gusto to scouring the internet for cheap deals on flights, hotels, hire cars and even package holidays, dispensing with intermediaries. Mr Frenzel expects the proportion of TUI's trips sold online to increase from 20% to at least 30% and perhaps as much as half over the next few years. He also predicts that the business models of web-based travel companies and traditional travel firms will converge. Traditional firms will try to reap savings by selling more online, and web-based companies will try to improve margins by making block bookings of hotel rooms and reselling them.

The European Commission must still review the two mergers on competition grounds. Lawyers reckon the process might take three months. But the commission will tread carefully. In 2002 Europe's top court embarrassed it by reversing its decision to block the merger of Airtours (now MyTravel) and First Choice. The commission, it said, had barred the merger on the basis of incomplete information and unfair decisions. This time around the travel firms can argue that competition has actually increased, thanks to the online travel boom.

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Virgin America

Flying the flag

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A domestic airline with foreign connections edges closer to launch

WE WANT to change the way you fly, says Virgin America to its prospective American passengers. We want to change the way you are run, replies the Department of Transportation (DOT), which gave tentative blessing to the new airline on March 20th in return for a host of changes to its ownership and management structures. Rival carriers will doubtless contest the decision, but Virgin America is hopeful that it can begin operating domestic flights from its San Francisco home this summer.

It has been a long haul. Virgin America's first application to fly, filed in 2005, failed the government's stringent citizenship tests for domestic airlines, which bar foreigners from owning more than 25% of the voting capital and from exercising practical control. Regulators had judged that Virgin Group, the empire of Sir Richard Branson, a British billionaire, would really be pulling the strings.

To break the logjam, in January Virgin America proposed a series of changes to its structure, including dropping the number of board seats held by Virgin Group and putting the British group's voting shares into the hands of an American trustee. The airline also offered to remove its chief executive, Fred Reid, whose American citizenship failed to allay suspicions about his close ties to those perfidious foreigners. The concessions appear to have done the trick. DOT officials described the proposals as “fundamental and highly constructive” (although that did not stop them adding a few more stipulations of their own).

American travellers should welcome the prospect of more competition. European passengers may also have gained. The news on Virgin America came just before European Union transport ministers approved an “open-skies” deal between America and the EU which leaves rules on foreign ownership of American carriers untouched. America's pledge to negotiate further on this issue may have seemed more credible because the door is now ajar for Virgin America.

But others might see Virgin America's hard-won certification more as a demonstration of the high barriers to entry in America than as proof of their erosion. The DOT's objection to Mr Reid, a respected veteran in the industry, because he might be beholden to foreign interests looks particularly meddlesome. The delays in certification have also hurt the airline, which is now set to enter the market at a tough time, says Keith McMullan of Aviation Economics, a consultancy. Rival carriers are in better shape than a few years ago; the supply of aircraft and pilots is also much tighter.

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Video games

Console wars

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All three combatants claim victory

AFP

The foot-soldiers assemble

IT IS a vicious fight—and one that all three participants claim to be winning. Sony, Microsoft and Nintendo are battling for supremacy in the $30 billion video-games industry, a struggle that takes place in rounds lasting five or six years each. The previous round, which began in 2000, pitted Sony's PlayStation 2 (PS2) against Microsoft's Xbox and Nintendo's GameCube. (Sony won, achieving a market share of 70%.) The present round began in 2005, when Microsoft began to sell the Xbox 360. Last year Nintendo came out with its new console, the Wii, and Sony shipped the PlayStation 3 (PS3) in America and Japan. With the start of sales of the PS3 in Europe on March 23rd, all three machines are at last available in all of the world's biggest markets. The fight is just getting started, and already everyone claims to be on top.

Microsoft can justly boast to have sold the most consoles: 10m Xbox 360s since launching the machine in November 2005. The 360 is popular in America and Europe, but is doing badly in Japan (though not quite as badly as the original Xbox did). The head start means that the 360 has by far the best line-up of games, the main reason for buying consoles. Microsoft's online service, Xbox Live, is also impressive, offering game and video downloads and allowing gamers to play together online.

For its part, Nintendo can boast that its new console has taken off the fastest, having sold nearly 6m units since November. The low-cost Wii is proving so popular that it is still hard to come by months after its launch, and is generating by far the most buzz. In part this is because the Wii's motion-sensitive controller means even non-gamers can quickly start playing tennis, golf or bowling. Nintendo hopes this will help to expand the market: non-gamers, it argues, are put off by the complexity of modern games. But sceptics warn that the Wii's novelty could wear off, that it lacks the “high-definition” graphics of its rivals, and that its online features are somewhat rudimentary.

What about Sony? The ageing PS2 outsold both the Xbox 360 and the Wii in America during December, so arguably it still rules the roost. Its maker insists that the PS3's relatively modest sales—2m units since November—are the result of supply shortages, though anecdotal evidence suggests that PS3s are far easier to find than Wiis. The PS3's high price—$499 and $599 in America, and €499 ($660) and €599 in Europe—may be putting buyers off, or prompting them to wait for price cuts. Sony says sales will take off once supply increases. This month it unveiled Home, an impressive virtual world similar to Second Life, which will become available on the PS3 in October and might also boost sales.

Analysts are divided about the outcome. The PS2 “achieved a level of market dominance never seen before, and I'm not sure we'll see again,” says Ed Barton, an analyst at Screen Digest. This time around, he suggests, different winners might emerge in different markets: it seems likely that Sony will do best in Japan and Microsoft in America. The wildcard is the Wii, which could trump the competition by attracting entirely new customers. IDC, a market-research firm, predicts that the Wii will be the bestselling console by 2008, and Merrill Lynch predicts that 30% of American homes will have a Wii by 2011. But Mr Barton warns that the Wii's success depends on publishers producing distinctive games for it. Also, its relatively underpowered hardware could soon look feeble next to the stunning graphics of its rivals.

So far, then, Microsoft has put in a solid performance, Nintendo is doing better than expected and Sony worse. The stakes are highest for Sony, which desperately needs the PS3 to succeed, both to protect its lucrative gaming franchise and to ensure success of its Blu-ray high-definition disc format, on which the

PS3 is based. Let battle commence in earnest.

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Health-care mergers

Meandering giants

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Pharmaceuticals firms are getting bigger, but not necessarily nimbler

COULD the global drugs business be on the cusp of another round of consolidation? Earlier this decade, a frenzy of deal-making saw Pfizer gobble up Pharmacia and Warner Lambert, Glaxo Wellcome join hands with SmithKline Beecham and Sanofi merge with Aventis. As the industry digested those deals, each of which was worth more than $50 billion, it seemed as though the acquisition spree might have come to an end. Talk of “diseconomies of scale” put a dampener on the appetite for further deal-making.

Some recent smaller deals suggest that such talk may have been premature. Earlier this month America's Schering-Plough announced the $14 billion acquisition of Organon BioSciences, a Dutch maker of contraceptives. Last week shareholders in Caremark, an American drugs middleman-cum-wholesaler, agreed on a $27 billion merger with CVS, an American drugstore chain. That decision ended a long-running battle over Caremark between CVS and Express Scripts, Caremark's main rival in “pharmacy benefit management” (PBM), in which big intermediary firms use their purchasing power to secure discounts on drugs for corporate clients. And on March 19th Community Health Systems, a hospital operator, agreed to buy Triad Hospitals for $6.8 billion.

Several factors are behind these deals. One is big pharmaceutical firms' struggle to keep new products coming through the research pipeline. Arjun Bedi of Accenture, a consultancy, reckons the number of drugs approved has fallen by half in the past seven years as the cost of developing them has doubled. One reason Schering-Plough bought Organon was to gain access to its promising late-stage experimental drugs for mental disorders and insomnia.

Another reason, argues Fred Hassan, chief executive of Schering-Plough, is that scale helps in developing novel drugs. That is a conclusion being reached by many smaller drugs firms, which had once hoped to remain independent. Organon was only the latest of many middle-sized European drugs firms to succumb to a takeover: Switzerland's Serono and Germany's Schering, Altana and Schwarz were all sold in 2006. In a new report analysts at Credit Suisse, an investment bank, argue that Britain's GlaxoSmithKline and Switzerland's Novartis are the most “natural acquirers” today, with Britain's Astra Zeneca and America's Wyeth and Bristol-Myers Squibb (BMS) as the “natural targets” in the next wave of consolidation.

Julien Dormois of Bryan Garnier, an investment bank, goes further. He speculates that the quest for economies of scale and a “global sales footprint” may prompt the purchase of the remaining middle-ranking firms, including Bayer and Merck in Germany and Abbott and Wyeth in America. He thinks Schering-Plough's acquisition of Organon, a big transatlantic drugs merger, might indicate that governments' desire to preserve national champions is at last waning.

Not everyone is convinced the drugs business is about to see another round of mergers. Even Mr Hassan accepts that those diseconomies of scale sometimes kick in. Growing too big can stifle the innovative culture that smaller firms tend to have—inducing what he calls “the meandering giant syndrome”. When poorly managed firms get bigger, he reckons, they sometimes lose their sense of identity and employees lose their enthusiasm.

Accenture's Mr Bedi is sceptical of the received wisdom that bigger drugs firms will lead to more successful drug discovery. He thinks a better way to revive the research pipeline is through radically rethinking the research model. He points approvingly to two outsourcing deals announced by BMS this week: the firm's researchers in America will farm out more number crunching and technical support to Accenture's Indian arm and it will even hand over some drug-discovery work to Biocon, an Indian biotechnology firm.

Yet Mr Hassan has identified a new factor in deals that was also in evidence this week: consolidation among the PBMs and drugstore chains that are the large drug firms' customers. Ask Thomas Ryan, boss of

CVS, about the logic of his firm's acquisition of Caremark, and he starts to use phrases like “purchasing leverage”. He calculates that 90% of his deal's synergies comes from the merged firm's ability to negotiate lower prices from drugs firms. Becoming bigger may not necessarily solve the pipeline problem, but it certainly helps you to match the increasing power of your customers.

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BP

In their own words...

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From The Economist print edition

BP's safety standards are condemned by those 'closest to the valve'

THE Chemical Safety Board, an American government agency that investigates industrial disasters, has long maintained that in the past BP's bosses did not spend enough time and money on the safety of their employees. Its latest report on the subject, released on March 20th, was no different: it argued that such failings contributed to an explosion in 2005 at BP's refinery in Texas City, Texas, which killed 15 people and injured 180. This time around, however, the board also published documents that tell of the employees' misgivings in their own words:

"For the last ten years, maintenance budget allocation has been controlled centrally by a 'top down' allocation of funds," consultants investigating frequent breakdowns at the refinery wrote in 2002. "Budget cuts were imposed based on the previous year's spend and did not take into account the specific needs of the refinery...The prevailing culture at the Texas City Refinery was to accept cost reductions without challenge and not to raise concerns when operational integrity was compromised."

AP

They saw it coming

Orders to slash costs by 25% seem "to have been taken literally" by those in charge of Texas City, whereas managers elsewhere "knew how to play the BP game", an employee notes in an internal e-mail, again in 2002. He refers to a colleague who thinks that "the top level in London need to understand the consequences of their orders."

An internal audit of Health, Safety and Environment (HSE) throughout BP, released in 2004, found "widespread tolerance of non-compliance with basic HSE rules...poor implementation of HSE management systems...lack of leadership competence and understanding to effectively manage all aspects of HSE...[and] insufficient monitoring of key HSE processes."

Many workers at Texas City complained that "managers were not nearly worried enough about the 'real' dangers and 'too worried about seat belts'," according to another set of consultants. Others griped that it was "acceptable to avoid costs related to integrity management because the consequences might occur later, on someone else's watch."

In their report, the consultants say they had "never seen such intensity of worry among people 'closest to the valve' about the potential for fires, explosions and other catastrophic events". They had also "never heard so many people say they were personally afraid of injury."

BP says it was aware of problems at Texas City thanks to such reports, and had already increased spending to fix them when disaster struck. But not all of its own employees seem satisfied with this explanation. Another internal e-mail, written a few weeks after the disaster, plaintively notes: "It's a shame what had to happen to get us to where we recommended we go several years back."

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Doing business in China

An inspector calls

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Foreign brands encounter a new form of protectionism

THIS week's target, on China's Consumer Rights Day, was PSA Peugeot Citröen, a French carmaker. Newspapers across the country published pictures of one of its cars being towed to a dealer by four bedraggled horses. The car's owner, a Mr Chen, claimed it was defective, despite damage that looked suspiciously like the result of a head-on collision. The car had “exploded for no reason”, Mr Chen told reporters, who dutifully relayed his story unquestioned.

The rights of 44% of Chinese consumers, says the official Consumers' Association, have been “seriously violated” in the past year. It has recommended a ten-point action plan to tackle the problem. The uninitiated would be forgiven for thinking that its campaign was aimed at local firms, which are notorious for churning out shoddy or dangerous goods. But much of the venom in the press, at any rate, is directed at big multinationals.

One company to have suffered from a safety scare is Procter & Gamble. Last September the authorities banned its SK-II beauty products after they found traces of chromium and neodymium. Never mind that these substances are tolerated throughout the world, are in locally made cosmetics and that the quantities were less than 1% of the level the World Health Organisation considers acceptable in foods. Newspapers reported that the creams could cause skin irritation and damage to the liver and lungs. Thousands of consumers stormed stores to demand refunds (often for counterfeit products). An angry mob smashed the glass doors of P&G's offices in Shanghai. A month later the Ministry of Health declared SK-II products safe. Yet even now, six months on, P&G has been able to restart SK-II sales in only 19 out of 98 former outlets.

Eating can be a risky business in China: 87 people died in one recent outbreak of food poisoning. Yet the authorities and the media seem oddly fixated on the supposed transgressions of foreign firms. Earlier this month health inspectors began looking into KFC's practice of adding a preservative called magnesium trisilicate to cooking oil and then reusing it for up to ten days. The press pounced on the story, drumming up experts who claimed that eating food cooked this way could cause cancer. Inevitably, the papers devoted much less coverage to the investigation's eventual findings: that KFC complied fully with local safety standards. Other foreign food-makers, including Häagen-Dazs, Heinz, Kraft and Nestlé, have suffered similar bad publicity.

Such stories are commonplace. Upon discovering that Johnson & Johnson's baby-care products were under scrutiny in India, newspapers in Chengdu advised consumers to stop buying them. Yet, after investigating, the Ministry of Health concluded that they met local regulations. Likewise, the media claimed that Unilever's Lipton instant tea contained fluorides which “would cause cancer if taken in excess”, according to one report. Yet the Ministry of Agriculture cleared the company after it provided samples for testing. Colgate-Palmolive's toothpaste was said to contain a carcinogen. In response, supermarkets in Shandong Province removed it from their shelves. Yet again, after an investigation, Colgate was cleared of any wrongdoing.

In January inspectors from the Shanghai Industrial and Commercial Administrative Bureau began an investigation of foreign designer clothing. It found that 17 of 40 brands tested were selling “substandard” goods. But the faults it uncovered were hardly the stuff of lawsuits. MaxMara and Burberry were both pulled up for selling trousers that “fade easily” while Armani's Collezioni jackets were singled out for lacking “fibre content”. Other big brands were accused of using poor dyes or having bad colour quality. Makers of designer goods, of course, are no more infallible than other firms, but the companies concerned cannot help wondering whether they are victims of a new form of protectionism—bad publicity.

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Face value

Rocket Man

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Elon Musk is part playboy, part space cowboy

SpaceX

IT IS midnight at the Playboy mansion and Elon Musk is in the cigar alcove with a couple of friends, holding forth. His vantage point gives him panoramic views of the goings-on at the party and easy access to the poolside bunnywalks. He seems like just another wealthy playboy. After all, when he is not partying with Playmates, Mr Musk likes to entertain in style at his pricey Bel Air home and speed around Los Angeles in his million-dollar McLaren racer.

But Mr Musk has no sense of occasion. He is talking expansively about saving the planet and conquering space. Moreover, unlike other Silicon Valley “thrillionaires” who throw money earned in the internet boom into voguish new hobbies, he is proving to be just as original in his thinking about his new pursuits as he was about his old ones.

On March 20th the Falcon, a two-stage rocket owned by Mr Musk's Space Exploration Technologies (SpaceX), lifted off from the Marshall Islands and climbed to an altitude of some 200 miles. Although the second stage failed to reach its intended orbit, the Falcon can claim to be the first rocket designed, developed and financed by the private sector that is anywhere near carrying a payload into space. Mr Musk founded SpaceX five years ago and designed much of the rocket himself.

Though he is only 35, Mr Musk has already made surprising progress toward the three modest goals he set for himself when at college: to transform the internet, make a breakthrough in clean energy and propel mankind towards inter-planetary travel. He arrived at Stanford University intending to do a doctorate on batteries for electric cars, but dropped out to jump on the internet bandwagon. He struck gold when he sold PayPal, the online payments firm, to eBay for $1.5 billion in 2002. Rather than retire comfortably, he says he “doubled down” his proceeds into his two other passions: clean energy and space.

The first bet was Tesla Motors, an electric-car company that is the first new American automobile firm in decades. Many consumers associate electric cars with golf carts and fear they will have only limited range; the motor industry refused to make them after a failed effort in the 1990s. Mr Musk may prove the nay-sayers wrong. In July Tesla unveiled its first model: a sports car which is faster than a Ferrari, more environmentally friendly than a Toyota Prius and can travel 250 miles after charging overnight

through an ordinary household socket. The first few have been pre-sold, but the concept will be properly tested only when they start rolling off the production line in August.

Taking on Detroit hardly counts as easy—except if you compare it with conquering space. Giant defence contractors close to the Pentagon and NASA, America's space agency, have long dominated the business of launching satellites. “Launch vehicles today are little changed from those of 40 years ago,” Mr Musk complained during a recent tour of his manufacturing facilities near Los Angeles airport. So he set about redesigning rockets from the bottom up.

Just near the entrance of a “clean room” on his shop floor, there is a large display of mechanical parts, engine components and other tired-looking bits and bobs. “That's all the stuff that didn't work,” he explains. The display highlights one of SpaceX's strengths: a culture of experimentation. His firm is stocked with experts poached from Northrop Grumman, Boeing and other aerospace giants. “These guys used to get frustrated at the old bureaucracies,” he says. “Here, it's more Google-ish.”

Breaking the space oligopoly

Because it was designed from scratch, the Falcon is much simpler than most rockets and thus free of some of the risks and costs of complexity. The version launched this week cost under $7m. SpaceX's competitors charge four or more times that for a launch. If Mr Musk's rockets can be recovered and recycled (he has designed them to be “used over and over like jet engines”), then the cost would fall even further.

In time, he believes his rockets will costs a tenth as much as his competitors' while lifting payloads much larger than they can. That matters, because the really big money is in the market for launching heavy payloads. But Mr Musk alleges that the industry has unfairly tried to keep him out. When the American air force recently awarded some two dozen future rocket launches to a consortium formed by Boeing and Lockheed Martin, the sector's dominant firms, SpaceX cried foul. It has sued them on the ground that they are colluding to keep low-cost competitors out—a charge both firms deny. SpaceX lost the initial case, but is appealing.

Entrenched incumbents are the least of SpaceX's problems. Mr Musk may fail simply because rocket science is, well, rocket science. He compares designing one to writing computer code that can be tested only in parts and which, when run for the first time, must be perfectly bug-free. The Falcon's first test a year ago ended in tears when a fuel leak after launch destroyed the rocket. Mr Musk sees this week's glitch as less serious. The launch, he says, “retired almost all of the significant development risk”, in that both lift-off and the separation of the two stages went smoothly. That has greatly encouraged the customers waiting for SpaceX to launch their satellites, including an arm of the Pentagon and the Malaysian government.

Falcon's progress has convinced Mr Musk that his dream of interplanetary travel may yet come true. “If normal humans ever travel beyond Earth, it will be because of SpaceX or companies like it,” he says. He reckons Mars is amenable to civilisation, and ought to be colonised as a “life-insurance policy” that guarantees the continuity of humanity. When mankind eventually gets to the red planet, the cars people will drive, Mr Musk fully expects, will be made by Tesla Motors.

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America's housing market

Cracks in the façade

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From The Economist print edition

America's riskiest mortgages are crumbling. How far will the damage spread?

Corbis

CASEY SERIN knows all about the excesses of America's housing bubble. In 2006 the 24-year old web designer from Sacramento bought seven houses in five months. He lied about his income on “no document” loans and was not asked for anything so old-fashioned as a deposit. Today Mr Serin has debts of $2.2m. Three of his houses have been repossessed; others could share that fate. His website, Iamfacingforeclosure.com, has become a magnet for those whose mortgages are in trouble.

Mr Serin and people like him are Wall Street's biggest uncertainty just now. How many Americans are saddled with mortgages they cannot afford on houses that are losing value? The answer matters to anyone who bought high-yielding mortgage-backed securities when a booming property market made mortgages look safe. It also matters to investment banks, which packaged the securities and often own subsidiaries that originate mortgages. It may determine whether America's economy falls into recession. It could even affect the outcome of next year's elections.

Most of the damage so far is in the “subprime” mortgage market, which lends to people whose income is too low, or whose credit history too patchy, to qualify for an ordinary mortgage. On March 13th the Mortgage Bankers Association reported that 13% of subprime borrowers were behind on their payments. Some 30 of America's subprime lenders have closed their doors in the past three months. The cost of insurance against default for the riskiest tranches of subprime debt has soared. The worst effects may not be felt until the mortgage payments of many borrowers with no equity in their homes rise sharply.

Is this a mere irritant in America's vast economy, or the start of something much worse? Opinion on Wall Street is divided. Most argue that the mortgage mess, though a blight on anyone caught up in it, will not spread. The number of mortgages at risk is too small for defaults to threaten everyone else. Even if a fifth of the $650 billion of adjustable-rate subprime loans went bad, that would be a blip in the $40 trillion market for debt. If repossessions extended the housing downturn, it would not derail an economy that—housing apart—remains healthy, with unemployment of 4.5% and jobs growing strongly.

Cellar signal

Growing numbers of pessimists disagree. They think the subprime squeeze marks the start of a broader credit crunch that could drag the economy into recession. Stephen Roach, the famously gloomy chief economist at Morgan Stanley, recently called subprime mortgages the new dotcoms. Just as the implosion of a few hundred internet ventures in 2000 sparked a much broader stockmarket correction and an eventual recession, so the failure of the riskiest mortgages may distress the rest of a debt-laden economy.

To try to assess who is right, you need to know the share of mortgages potentially at risk. And you need to understand the channels through which subprime defaults could spread to the wider economy.

America's residential mortgage market is huge. It consists of some $10 trillion worth of loans, of which around 75% are repackaged into securities, mainly by the government-sponsored mortgage giants, Fannie Mae and Freddie Mac. Most of this market involves little risk. Two-thirds of mortgage borrowers enjoy good credit and a fixed interest rate and can depend on the value of their houses remaining far higher than their borrowings. But a growing minority of loans look very different, with weak borrowers, adjustable rates and little, or no, cushion of home equity.

For a decade, the fastest growth in America's mortgage markets has been at the bottom. Subprime borrowers—long shut out of home ownership—now account for one in five new mortgages and 10% of all mortgage debt, thanks to the expansion of mortgage-backed securities (and derivatives based on them). Low short-term interest rates earlier this decade led to a bonanza in adjustable-rate mortgages (ARMs). Ever more exotic products were dreamt up, including “teaser” loans with an introductory period of interest rates as low as 1%.

When the housing market began to slow, lenders pepped up the pace of sales by dramatically loosening credit standards, lending more against each property and cutting the need for documentation. Wall Street cheered them on. Investors were hungry for high-yielding assets and banks and brokers could earn fat fees by pooling and slicing the risks in these loans.

Standards fell furthest at the bottom of the credit ladder: subprime mortgages and those one rung higher, known as Alt-As. A recent report by analysts at Credit Suisse estimates that 80% of subprime loans made in 2006 included low “teaser” rates; almost eight out of ten Alt-A loans were “liar loans”, based on little or no documentation; loan-to-value ratios were often over 90% with a second piggy-bank loan routinely thrown in. America's weakest borrowers, in short, were often able to buy a house without handing over a penny.

Lenders got the demand for loans that they wanted—and more fool them. Amid the continuing boom, some 40% of all originations last year were subprime or Alt-A. But as these mortgages were reset to higher rates and borrowers who had lied about their income failed to pay up, the trap was sprung. A new study by Christopher Cagan, an economist at First American CoreLogic, based on his firm's database of most American mortgages, calculates that 60% of all adjustable-rate loans made since 2004 will be reset to payments that will be 25% higher or more. A fifth will see monthly payments soar by 50% or more.

Few borrowers can cope with such a burden. When house prices were booming no one cared. Borrowers refinanced or sold their homes. But now that prices have flattened and, in many areas, fallen, those paths are blocked.

The greatest difficulties threaten borrowers whose house is worth less than their mortgage. Just under 7% of all American homeowners had this “negative equity” at the end of December 2006 estimates Mr Cagan, using a sample of 32m houses (see chart 1). Among recent homebuyers, the share is even higher: 18% of all people who took mortgages out in 2006 now have negative equity. A quarter of all mortgages due to reset in 2008 are in the same miserable state (see chart 2).

House of cards? 1

Cumulative distribution of homeowners' equity in their houses, 2006

Equity*	%†	Equity*	%†
Less than 30%	39.7	Less than 5%	11.0
Less than 25%	33.1	Less than 0%	6.9
Less than 20%	26.7	Less than -5%	4.3
Less than 15%	21.0	Less than -10%	2.9
Less than 10%	15.8		

*Value of house less mortgage outstanding as % of house value †Of a sample of 2m mortgaged properties

Source: First American CoreLogic

Higher payments and negative equity are a toxic combination. Mr Cagan marries the statistics and concludes that—going by today's prices—some 1.1m mortgages (or 13% of all adjustable-rate mortgages originated between 2004 and 2006), worth $326 billion, are heading for repossession in the next few years. The suffering will be concentrated: only 7% of mainstream adjustable mortgages will be affected, whereas one in three of the recent “teaser” loans will end in default. The harshest year will be 2008, when many mortgages will be reset and few borrowers will have much equity.

Home to roost 2

Cumulative distribution of properties with adjustable-rate mortgages taken out in 2004-06*

Equity†	%†	Equity†	%†
Less than 30%	86.2	Less than 5%	40.1
Less than 25%	79.0	Less than 0%	25.4
Less than 20%	69.5	Less than -5%	12.7
Less than 15%	60.8	Less than -10%	6.5
Less than 10%	51.3		

*With 2008 as year of first reset †Value of house less mortgage outstanding as % of house value ‡Of a sample of 8.4m adjustable-rate first mortgages

Source: First American CoreLogic

Mr Cagan's study considers only the effect of higher payments (ignoring defaults from job loss, divorce, and so on). But it is a guide to how much default rates may worsen even if the economy

stays strong and house prices stabilise. According to RealtyTrac, some 1.3m homes were in default on their mortgages in 2006, up 42% from the year before. This study suggests that figure could rise much further. And if house prices fall, the picture darkens. Mr Cagan's work suggests that every percentage point drop in house prices would bring 70,000 extra repossessions.

The direct damage to Wall Street is likely to be modest. A repossessed property will eventually be sold, albeit at a discount. As a result, Mr Cagan's estimate of $326 billion of repossessed mortgages translates into roughly $112 billion of losses, spread over several years. Even a loss several times larger than that would barely ruffle America's vast financial markets: about $600 billion was wiped out on the stockmarkets as share prices fell on February 27th.

In theory, the chopping up and selling on of risk should spread the pain. The losses ought to be manageable even for banks such as HSBC and Wells Fargo, the two biggest subprime mortgage lenders, and Bear Stearns, Wall Street's largest underwriter of mortgage-backed securities. Subprime mortgages make up only a small part of their business. Indeed, banks so far smell an opportunity to buy the assets of imploding subprime lenders on the cheap.

Discredited

Although subprime is a small direct threat to Wall Street it could still inflict pain on bankers—and the broader economy—in other ways. Investors are shunning subprime and all mortgages that seem risky. Spreads have dramatically widened on the securities backed by riskier mortgages and the pooled and debt-laden collateralised-debt obligations (CDOs) based on them. The issuance of subprime-related CDOs has plunged. That is a worry, because investors' appetite for these securities fuelled the boom in riskier mortgages.

Lenders' reluctance and tightening loan standards may combine to form a classic credit crunch. Several lenders, including Countrywide, America's largest mortgage lender, have stopped making no-money-down mortgage loans. HSBC has cut back on second-lien loans. Freddie Mac recently announced it would no longer buy some subprime loans. No one is sure how dramatic, or lasting, the pull-back will be, but Credit Suisse thinks the number of originations in subprime markets could fall by some 50% in the next couple of years and Alt-A loans may fall by a quarter. Even if the shift is confined to America's riskiest mortgages (and there is little evidence yet of tighter lending standards spreading), its effects may climb up the housing ladder.

Just when some would-be buyers find it harder to borrow, rising numbers of repossessions will increase the supply of homes for sale. The backlog of unsold homes is already high, at over 3.5m existing homes, or more than six months' sales. Counting the properties that have already been repossessed—and hence are all but certain to be for sale—that figure rises by about a fifth. Add the likelihood of some 1m more repossessions as adjustable-rate mortgages are reset, and you have the makings of a housing glut.

Falling demand and soaring supply bodes ill for construction and house prices, the main ways housing affects the broader economy. Builders have already cut back. The pace of housing starts is down 33% from its peak in January 2006. Plunging residential investment is the main reason America's GDP growth has slowed to 2.2%. But, as Nouriel Roubini and Christian Menegatti point out in a recent report, that retrenchment is modest by historical standards. In the seven construction busts since 1960, housing starts fell, on average, by 51% from their peak. The mortgage crunch makes matters worse. To work off inventories, builders will have to cut back more, dragging output growth down for longer. Job losses in construction and related industries, which have so far been mild, are likely to rise sharply.

A glut of unsold homes will also push down prices, particularly in areas such as California and Florida, which had a disproportionate share of riskier loans. House prices have already been falling in parts of both states, as they have in Midwestern states, such as Michigan, where manufacturing industry has shed jobs in recent years. Will those declines accelerate and spread?

By many measures, America's house prices are still too high. David Rosenberg of Merrill Lynch points out that the ratio of income to housing costs is still some 10% worse than its historical norm and 20% worse than levels at the end of the last housing downturn in the early 1990s. Take out a chunk of potential borrowers; add in some repossessed homes and house prices could be hit hard. If falling prices raise the rate of default, that could in turn worsen the credit crunch, putting yet more pressure on prices. Wall Street's gloomiest seers think average house prices could fall by 10% this year. If so, the economy could well enter a recession.

Consumers have shrugged off the housing slowdown thus far: real consumer spending is still growing at annual rate of some 3%, thanks largely to strong job and wage growth. But they are unlikely to shrug off a 10% plunge within one year, particularly since America's homeowners have become used to their housing wealth rising by well over 5% a year. No one is sure just how responsive consumer spending is to changes in house prices. Economists normally reckon that a $100 drop in wealth eventually reduces spending by $3-5 a year. But some recent studies suggest the “wealth effect” from housing may eventually be more than double that. Given that Americans have $20 trillion of housing wealth, a 10% price drop could easily halve the pace of consumer spending growth, sending the economy perilously close to recession.

Such a dramatic drop in national house prices this year is possible, but not yet probable. Unlike share prices, house prices rarely plunge in nominal terms. Unless repossession forces a sale, homeowners prefer to sit tight when markets are weak. If house prices stagnate, consumption may suffer a little, but not too much, so long as jobs stay plentiful and wages grow. If so, the mortgage crunch will be a grinding drag on America's economy; one that unfolds over several years, hitting some people and some regions hard, but not, in itself, a macro-economic disaster.

The bursting of the stock-market bubble in 2000 led to a plunge in investment at American firms. To stave off recession, the Federal Reserve loosened monetary policy. Short-term interest rates fell to historic lows, propping up consumer spending, but also fuelling the housing bubble and sowing the seeds of today's upheaval.

Any such loosening is much less likely today. As the statement at their meeting on March 21st made clear, America's central bankers are still more worried about inflation than about recession. And with reason. Core consumer price inflation, which excludes the volatile categories of food and fuel, has accelerated, to 2.6% at an annual rate in the three months to February. With inflation higher than they would like, the central bankers are in no hurry to slash interest rates. They would lose little sleep if output growth stays sluggish or unemployment rates inch up.

The Senate and the houses

In contrast to the dotcom bust, then, the consequences of the housing market's troubles may be felt more sharply on Capitol Hill than at the Fed. Politicians, particularly the Democrats now in charge of Congress, are clamouring for quick action. Hillary Clinton has declared the market “broken”, accused the Bush administration of standing by and demanded something be done. Chris Dodd, chairman of the Senate Banking Committee and another Democratic presidential candidate, is also up in arms.

George Bush often boasts about rising rates of home-ownership under his watch. Hundreds of thousands of repossessed homes, many of them from borrowers who are black and poor, would be politically incendiary. The Centre for Responsible Lending reports that half of the mortgages taken out by blacks in the past few years were subprime. If a fifth of those default, one in ten recent black homebuyers may end up losing his house. Many of these people have stories to tell of being duped into taking on mortgages that they did not understand and could not afford.

Pressure is mounting to right the wrongs—real and perceived. Attorneys-general from New York to California have started to investigate fraudulent mortgage lending. Rather as after Enron, the securities regulator in Massachusetts has demanded that UBS and Bear Stearns hand over internal details of their research coverage of subprime lenders. Congress has already held hearings on predatory lending. More are planned.

Ideas abound on what must be done. Mrs Clinton has called for a “ foreclosure time-out”. Pressure groups want Congress to rewrite the rules of the Federal Housing Administration (FHA), a federal organisation charged with providing affordable mortgages to the poor, so it can refinance subprime mortgage loans in default. Calls for other types of bail-out will rise.

America's four federal bank regulators are also scrambling to respond. Earlier this month they proposed stricter lending guidelines on adjustable subprime loans. But federal regulators play a limited role in subprime markets. Many of the riskiest mortgages were made by independent, non-bank lenders—such as New Century, Ownit and Fremont. These outfits (which are now collapsing) are overseen by state regulators, not federal ones—and the quality of state oversight varies widely. Only half of states have laws against predatory lending. Many lack rules requiring lenders to perform criminal background checks on brokers, as federal guidelines require.

Few doubt that the subprime mess was, in part, a regulatory failure. But now the mistakes have been made, the biggest risk is that populist politicians rewrite the rules hamfistedly. Fraudulent activity should be punished. The vulnerable need protection from predatory lenders. But an ill-conceived swathe of new “consumer protection” could easily make matters worse. If restrictive regulation scared investors away from the subprime market for good, that really would hurt the poor.

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European bank mergers

Revving up for a demolition derby

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Is the giant financial conglomerate a thing of the past—or is it the future?

AP

IT COULD signal the start of a race to rebuild European banking. Or, more prosaically, it could merely create the second-biggest bank in Europe. Either way, the exclusive merger talks between Barclays Bank of Britain and ABN AMRO of the Netherlands, is one of those heady moments when the engines roar, the petrol fumes drift across the track and the possibilities swim before the eyes.

Barclays approached ABN AMRO, which has been pressed by an activist investor to break itself up, as an act of mercy. Together the banks would engineer a juggernaut with a market value of some £130 billion ($170 billion) and interests running the gamut of retail and investment banking. The deal would be a defiant gesture that the age of the sprawling financial conglomerate is not over. But if the merger talks falter, other buyers will be keen to take a blowtorch to the Dutch champion.

That may be the choice of the Children's Investment Fund (TCI), a hedge fund that has just raised its stake in ABN AMRO to over 2%, and which last month called for the bank's annual general meeting on April 26th to consider a sale of divisions or the entire bank. TCI wants a two-month “go-shop” period, common practice in America. Other potential buyers could then do their due diligence and make better offers. In fact, Chris Hohn, who heads TCI, is threatening to sue Arthur Martinez, the chairman of ABN AMRO, if he fails to open opportunities to other buyers. “Allowing management to put the deal together is a clear conflict of interest,” says Mr Hohn.

What does ABN AMRO bring to the track? Its assets include a variety of commercial outfits added without much discipline, such as Banco Real in Brazil, LaSalle Bank in America and most recently Antonveneta in Italy. Some big Spanish, American and Italian banks would be happy to bid for those separately. Then there is its worldwide wholesale-banking business, which might attract other buyers wanting to do more business abroad.

Both UniCredit of Italy and Santander Central Hispano of Spain have shown that they can make foreign retail operations work, respectively with HVB in Germany and Abbey in Britain. They might pay a higher price than Barclays, especially in tandem with another firm interested in ABN AMRO's wholesale and investment banking.

And a break-up of ABN AMRO might lead to the dismantling of other conglomerates, such as ING, Fortis or even Allianz/Dresdner. It could also stimulate swaps of specialist banking divisions throughout the continent. Europe's banks, used to a comfortable ride around their own neighbourhoods, might enter their

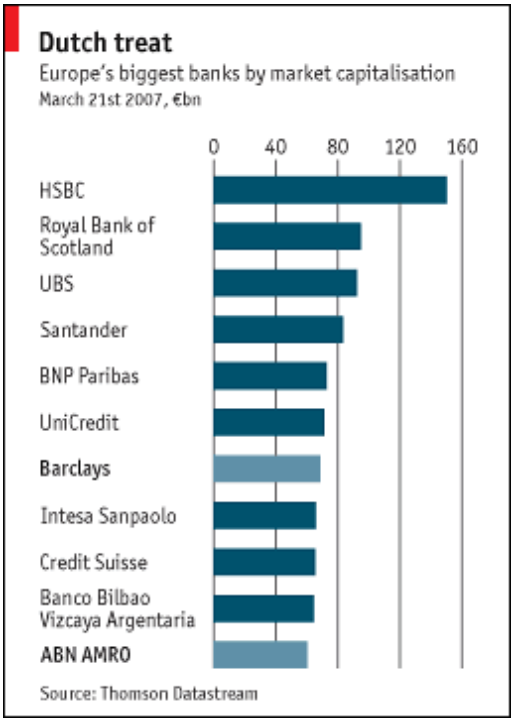
own demolition derby.

With ABN AMRO on the block, and two or more banks taking the bits they want, activist shareholders might feel emboldened to rampage across the continent. Europe is overbanked. It will be even more so when cross-border banking services become as cheap and seamless as domestic ones. Industrial companies have long chopped and changed their portfolios of businesses in step with prevailing conditions; banks have been slow to adopt the same strategy.

When TCI made its call last month, Nout Wellink, governor of the Dutch central bank, rushed to the defence of ABN AMRO—only to be slapped down by the European Commission for interfering with legitimate capital-market activity. Charlie McCreevy, the European Union's (EU) internal-market commissioner, will have a law in place soon that forbids national regulators from opposing bank mergers just because they are hostile.

No wonder that the Dutch establishment entertains a full merger with Barclays. The London-based bank has agreed to move the new group's headquarters to Amsterdam, which would save taxes and should also please Dutch regulators. The merger would not change Europe's banking landscape out of all recognition, and it would preserve jobs for ABN AMRO management and staff.

It is a sign that consolidation will happen slowly if it is left to bank management and their core shareholders. Banks are hesitant about making hostile bids for each other. They risk damaging their own reputation and their relationship with the target if the bid comes to nothing. Most long-term shareholders are also reluctant to rock the boat by threatening management with dismissal or the break-up of the institution. When TCI prodded ABN AMRO last month, “many large shareholders said thank you,” recalls Mr Hohn.



There are not many busybodies like TCI scouring Europe looking for signs of poor management and underperformance. “Shareholders have to be told when they are being short-changed,” Mr Hohn says. That is a pity. A free-for-all demolition would be unsettling for supervisors and their banking sectors. But better banks would emerge from the wreckage. TCI has shown that even a giant like ABN AMRO, with a market capitalisation of about €60 billion (see chart), is open to attack if it is badly run.

And if activist shareholders cannot prod Europe's banks into action, perhaps their customers can. By 2008 a proposed single euro payments area is supposed to allow credit transfers, direct debits and card payment services across the euro zone at a standard domestic price. Under this system, a customer could in theory operate throughout the zone with a single bank account in a country of his choice. This would remove one of the last barriers to cross-border competition. The banks are dragging their feet over payments, but they cannot resist for ever. If customers go European, the banks will have to follow.

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Buttonwood

What's it all about, alpha?

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From The Economist print edition

Demystifying fund managers' returns

TOO many notes. That's what Emperor Joseph II famously said to Mozart on seeing his opera “The Marriage of Figaro”. But surely to think of a musical work as just a series of notes is to miss the magic.

Could the same be said about fund management? It is the fashion these days to separate beta (the systematic return delivered by the market) from alpha (the manager's skill). Investors are happy to pay high fees for the skill, but regard the market return as a commodity. Distinguishing the two is, however, difficult.

A fund manager might beat the market because of luck or recklessness, rather than skill, for example. Suppose he packed his portfolio with oil stocks. When the crude price rises that would pay off, but it would be a pretty risky portfolio. More generally, alpha sceptics often attribute eye-catching returns to “style bias”, such as favouring stocks with a high dividend yield.

But should they be biased against style bias? After all, the only portfolio utterly free of bias would be one that included the entire market. Were a Britain portfolio to exclude just one stock, such as BP, it would have a small-cap bias, a sector bias and a currency bias (most of BP's revenue is in dollars). Hence any excess return must stem from some element of style.

Academics have entered this debate, trying to pin down the factors that drive a fund's performance. These might include the difference in returns between small-cap and large-cap stocks (fund managers tend to favour the former) or the level of credit spreads and so on. Bill Fung and Narayan Naik of London Business School have come up with a seven-factor model which, they say, can explain the bulk of hedge-fund performance. After allowing for these factors, the average fund of hedge funds has not produced any alpha in the past decade, except during the dotcom bubble.

This approach suggests the whole idea of alpha might be an illusion. Academics can explain most of it, and the only reason they cannot explain all of it is because they are not clever enough to think of the missing factors.

However, it is also possible to take the opposite tack. This type of analysis gives managers no credit for choosing the systematic factors—the betas—that drive their portfolios. Yes, these betas could often have been bought for very low fees. But would an investor have been able to put them together in the right combination?

It is as if a diner in Gordon Ramsay's restaurants were brave enough to tell the irascible chef: “This meal was delicious. But chemical analysis shows it is 65% chicken, 20% carrot, 10% flour and 5% milk. I could have bought those ingredients for £1.50. Why should I pay £20?” The chef's reply, shorn of its expletives, might be: “The secret is in the mixing.”

This debate matters because people are now trying to replicate the performance of hedge funds with cloned portfolios. Indeed Messrs Fung and Naik have shown that their model would have produced an annual return over the past four years of 11.6%, well ahead of the average fund of hedge funds. Their performance was purely theoretical. But Goldman Sachs and Merrill Lynch have launched cloned hedge funds on the market.

There are two potential criticisms of the cloned approach. One is that it will simply reproduce all the systematic returns that hedge funds generate and none of their idiosyncratic magic. However, this “magic” is hard to pin down. Even if it does exist, Messrs Fung and Naik suggest it may be worth no more than the

fees hedge funds charge, so the managers are the only ones to benefit from their skills.

The second criticism is that the clones will always be a step behind the smart money. You cannot clone a hedge fund until you know where it has been. But by then it may have moved on. As a result, the clones may pile into assets that the hedge funds are selling, making the classic mistake of buying at the top. This may not be a fatal flaw, however. It is possible to imagine some clones taking contrary bets, buying the betas that seem temporarily out of favour, in the hope that they will be purchasing what the hedge funds are about to buy.

There are some nice ironies at work here. Hedge-fund managers often rely on secretive “black box” models: the investor puts his money in at one end and sees the returns spat out at the other, but no more than that. Now, armed with just that information, academics are coming up with their own models, which almost match the hedge funds' performance.

Mozart might have sympathised. His operas were more than the sum of his notes. But even if the great composer had no peers, he has had plenty of imitators.

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Exchanges

A look into the future

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From The Economist print edition

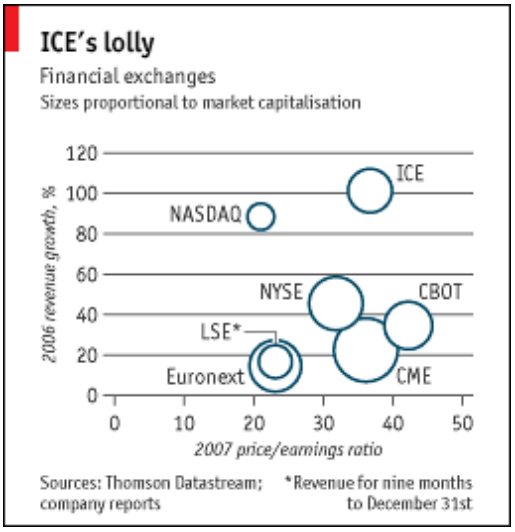
A takeover battle highlights a lucrative corner of the financial markets

THE futures industry, despite its name, was long viewed as a somewhat backward relation of the stockmarkets. The caricature was of a rough-and-tumble place where bulky men with loud voices—the sorts who hailed from Essex or the south side of Chicago—made bets on the prospective price of crude oil and pork bellies.

These days, however, “futures” is a more fitting description. The trillions of dollars zapping through the markets are usually moved electronically, allowing traders to hedge investments in everything from shifts in the currency to turns in the weather. More diverse, creative and lucrative than equities, this arcane activity has now attracted the interest of the world's biggest investors.

An increasingly heated takeover battle for the Chicago Board of Trade (CBOT), one of the world's leading futures exchanges, has sent its market value soaring. In one corner sits the Chicago Mercantile Exchange (CME), a former cross-town rival of the CBOT. After years of barbed competition, it recently struck a deal to acquire the CBOT's parent company for $8.9 billion. But some customers have squirmed at the thought of such a giant controlling about 85% of America's market for exchange-traded futures, and regulators are scrutinising the proposed merger on anti-trust grounds.

That set the stage for a competing, unsolicited $9.9 billion offer for CBOT by the Intercontinental Exchange (ICE), an all-electronic upstart that has grown fast through acquisitions on both sides of the Atlantic (see chart). With shareholders ranging from Goldman Sachs to BP, ICE has seized London's International Petroleum Exchange and the New York Board of Trade. It is now a force to be reckoned with in products ranging from oil and gas to coffee and cocoa.



Both CME and ICE were busy wooing the CBOT's members and shareholders this week. Many traders seem to favour the ICE deal. John Lothian, who publishes a widely read industry newsletter, told his readers this week that he favours “a competitive exchange environment” (meaning the ICE bid) over “a huge exchange fortress.” CBOT shareholders may agree: the ICE deal looks likely to preserve more jobs than the rival bid, and would offer some potentially lucrative financial perks to CBOT members.

Whatever the outcome of this contest, futures are clearly where the money is. This is largely thanks to active investors, including hedge funds, who use futures in crafting increasingly complex multi-asset, cross-border trades. If they can execute these trades at the press of a button, on a single exchange, then all the better. One reason the New York Stock Exchange (NYSE) is merging with Euronext, a pan-European exchange operator, is to expand into these asset classes through Euronext's Liffe derivatives market.

Blessed with a popular product, the futures exchanges also enjoy high barriers to entry. Building a futures exchange from scratch is much harder than inaugurating another stockmarket—indeed, newcomers and regional exchanges have been able to grab a sizeable chunk of share-trading volume from the biggest markets. Yet unlike shares, which can be traded in various venues, futures contracts are almost always concentrated on the exchanges that created them. The absence of strong competition gives the exchanges some power to set their prices, which helps explain why exchanges that trade derivatives are valued more highly than those that stick purely to share trading.

Another valuable attribute is that a futures trade is usually cleared by the exchange on which it was made. By keeping a hold on clearing, exchanges benefit from a particularly profitable step in the trading cycle. They see this as fair compensation for their investment in innovation, according to Ruben Lee, an analyst. A notable exception to the own-clearing rule is the CBOT's agreement to clear trades through the CME, a lucrative arrangement for the Merc, which is threatened by the ICE bid.

The stiffest competition for these exchanges comes from over-the-counter markets, which handle bespoke bilateral trades, often between banks. But now the exchanges are moving in this direction too, potentially putting them in direct competition with their biggest customers. ICE, for instance, already has a busy over-the-counter business. That, in the end, may be where the futures lie.

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Enron litigation

Laying down

Mar 22nd 2007 | NEW YORK
From The Economist print edition

Bad news for banks that settled early with Enron's shareholders

DEFENDANTS in American securities suits do not always know how strong a hand they hold. They may fight and lose their case, when they should have settled. Or they may fold too early, when they could have stayed in the game and won.

Folding a strong hand is what Citigroup, JPMorgan Chase and Canada's CIBC appear to have done. In 2005, under pressure over their alleged roles in the fraud that felled Enron four years earlier, they each agreed to settle with the bust energy trader's shareholders for $2 billion or more. Though the sums were huge, they calculated that fighting on would only prolong the agony. That after all was the fate of lenders who refused to settle promptly in a case involving WorldCom, another dotcom-era implosion.

But in light of a court ruling this week, the banks look to have made an unwise bet. Reversing an earlier decision by a district judge, a federal appeals court ruled that a class action pitting Enron shareholders against three banks that had refused to settle could not go ahead. “Pleased” in public, the lenders—Credit Suisse, Merrill Lynch and Barclays—were privately cock-a-hoop. They may now avoid paying even a cent to the shareholders. It was also good news for holdouts in a separate Enron-related case, including the Royal Bank of Scotland and Toronto Dominion, which also stand to benefit. The plaintiffs, corralled by Bill Lerach, a lawyer, were aghast. They had been seeking $40 billion in total from those with any kind of link to the firm's accounting shenanigans.

Under a principle known as “scheme liability”, Mr Lerach had argued that Enron's financial advisers should be on the hook because they had helped devise its schemes to park debt off its balance sheet and inflate its revenues. But the three-judge panel ruled that even if the banks had “aided and abetted” fraud “by engaging in transactions to make it more plausible”, they owed no duty to Enron's shareholders. In essence, they decided that only those who mis-state accounts, not those who assist them, can be sued *en masse*.

That may seem unfair, but it is likely to stand. Though Mr Lerach and his lead plaintiff, the University of California, plan an appeal to the Supreme Court, few legal experts think the justices will take up the case. This is probably the end of the road for most shareholders, if not all. Though they can still sue individually, even the biggest awards would not match the costs of a prosecution.

Some see the ruling this week as yet more evidence of the tide turning against securities class actions. It follows a similar decision in December against plaintiffs looking to sue banks over their underwriting of public offerings. Judges are increasingly acknowledging that class-action certification, designed to be a mere step in the litigation process, all too often puts defendants under unbearable pressure to settle, even when they have a reasonable chance of winning on merit. But, as Adam Savett of Institutional Shareholder Services points out, securities law is still a largely unsettled area, reflected in the very different decisions emerging from the various appeals-court circuits. Banks that call their opponents' bets in the legal poker game will not always be as lucky as the three that prevailed this week.

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Blackstone's IPO

Bigger than Rod

Mar 22nd 2007 | NEW YORK
From The Economist print edition

A private-equity giant prepares to go public

STEPHEN SCHWARZMAN, who has presided over many eye-catching takeovers, recently cemented his reputation as the new king of Wall Street with a lavish 60th birthday party. Among the numerous celebrities at the event was Rod Stewart. The big-haired songster, known for classics such as “Maggie May” and “Da Ya Think I'm Sexy?”, wooed the ladies with his gravelly voice. But for the moneybags present, his pulling power was nothing compared with that of Blackstone, the hugely powerful firm that Mr Schwarzman co-founded. The private-equity giant may be about to get hotter still. Reports suggest it will soon be floated on the stockmarket. Such a move would turn many a head in the industry, which has grown into a dominant force in deal-making.

Blackstone is believed to be in the advanced stages of planning an initial public offering (IPO) of a minority stake, perhaps 10%. Though it would not be the first “bulge-bracket” buy-out shop to embrace the market—Kohlberg Kravis Roberts (KKR) has listed a fund in Europe, for instance—it would be the first to float the main management company. Predicting its value is not easy given Blackstone's broad range of businesses, encompassing hedge funds, property and advisory arms, as well as leveraged buy-outs of public companies. Appraisals range from $20 billion to double that. Blackstone's managers, perhaps inspired by Mr Stewart's “I Don't Want To Talk About It”, are keeping mum.

The move is steeped in irony. Mr Schwarzman has derided public ownership, calling stockmarkets “overrated”, and bashed the Sarbanes-Oxley act, which clamps corporate-governance manacles on listed firms. One blogger described his conversion as “the most unlikely...since Saul of Tarsus fell off his horse en route to Damascus”. But his supporters see no hypocrisy at all: Blackstone's bosses know the value of public markets only too well, since they need them to buy back the companies in its portfolio when they want to cash in their gains.

Nor is the news particularly surprising. The successful IPO last month by Fortress, a hedge fund and private-equity firm, showed that there is plenty of demand for “alternative” assets among small investors whose access to private markets is restricted. Long before that, big private-equity groups such as Texas Pacific and Carlyle were mulling similar moves. They will watch Blackstone's progress closely, just as Wall Street's investment-banking partnerships studied Bear Stearns when it went public in 1985.

But Blackstone's model is more likely to be Goldman Sachs, which has thrived, and retained much of its partnership mystique, since floating its shares in 1999. It may hope to use shares as a currency with which to reward its 750 employees, as Goldman has so generously done. A listing may also allow a new generation of managers to come forward, as the old guard loosens its grip. Blackstone is stuffed with over-achieving 20- and 30-somethings, such as Jonathan Gray, who masterminded the recent $39 billion takeover of Equity Office Properties.

Few doubt that the clearest winners would be Blackstone's owners and the tight group of senior managers around them. A listing would allow them to extract and diversify some of the value tied up in the company. Mr Schwarzman could free up part of his stake, thought to be 40%, without losing control. He may, however, lose the respect of some of Blackstone's “limited partners”, the institutions and wealthy individuals who invest in buy-out funds, if the move is construed as a brazen attempt to cash out at the top of the market. He and other private-equity bosses have acknowledged that the good times cannot last forever. Blackstone's returns last year and the year before topped 100%, unsustainable in any industry.

Indeed, the limited partners would have few reasons to celebrate an IPO. They would suffer if Blackstone came under pressure from the market to support returns by raising its already plump fees. Some of them might decide to stop investing in its funds and buy its stock instead, retaining exposure without having to hand over a 1-1.5% management fee and 20% of investment gains.

Blackstone itself might discover drawbacks too. It would have to disclose more information—lawyers argue over how much—and it would be shackled by what Mr Schwarzman has called the “tyranny of quarterly earnings”. On the other hand, greater transparency might reduce the pressure from critics of private equity, who caricature the industry as a destructive force, stripping assets in the shadows.

Josh Lerner of Harvard Business School points to two other potential problems, one caused by too much liquidity, the other by too little. A public Blackstone would have to learn to live with fickle small investors, who, unlike the current crop, could sell at the first sign of trouble. And the stockmarket may fail to appreciate the lumpiness of the firm's earnings. Private-equity gains are realised at irregular intervals, when holdings are sold. This is one reason why KKR's listed fund trades below its net asset value.

So, as admired as Blackstone is, a public offering would bring new risks. But for those who have built the firm up to its giddy heights, the rewards must seem more palpable. If stockmarkets keep their composure in the run-up to the flotation, and credit markets remain benign, Mr Schwarzman's next birthday bash may—Rod willing—be treated to a storming version of “Some Guys Have All The Luck”.

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Accounting scandals

Japanese massage

Mar 22nd 2007 | TOKYO
From The Economist print edition

The livedoor case comes to a head, but plenty of other accounting scandals are still out there

THE arrest early last year of Takafumi Horie, the publicity-hungry maverick who ran livedoor, an internet company, gripped a media-obsessed nation. It became the fizziest scandal in Japanese corporate history. His indictment on charges of falsifying profits and creating a false market in livedoor's shares brought his $6 billion company crashing down. The collapse caused chaos on the Tokyo Stock Exchange (TSE) and much fuss and chatter on the evening talk shows. Mr Horie (pictured) continues to attract attention: on March 16th he was found guilty of securities fraud and sentenced to two and a half years in prison. On March 22nd a fellow executive, Ryoji Miyauchi, who turned prosecution witness, was also found guilty and given a two-year jail term.

These sentences are unusually harsh for Japan, where white-collar crime typically carries a suspended term. But then the typical establishment crook is quick to express remorse. Mr Horie on the other hand has protested his innocence to the end and will appeal against his conviction.

AP

From livedoor to locked doors

Even without Mr Horie's talent for publicity, the spotlight would remain on auditing irregularities and the policing of securities laws in Japan. Another company that has rapidly fallen from grace is Misuzu Audit, formerly ChuoAoyama PricewaterhouseCoopers. Once Japan's third-biggest audit firm, it used to count Sony, Toyota and Softbank among its clients. Late last month, Misuzu asked other leading auditors to take on its remaining clients as a prelude to its liquidation.

ChuoAoyama's problems began in earnest in 2005 when several of its accountants were arrested for allegedly conspiring with executives at Kanebo, a cosmetics company, to falsify the firm's accounts. ChuoAoyama had also audited Ashikaga Bank, a big regional bank in trouble with Japan's Financial Services Agency (FSA) for cooking its books to conceal its insolvency. As punishment, the FSA last summer barred ChuoAoyama from doing business for two months with almost all of its corporate clients.

That put its fate in the balance. The balance tipped late last year when it became clear the auditing firm had failed to notice that Nikko Cordial, Japan's third-biggest broker, had inflated its profits in the year to March 2005. Late last month another of its former clients—Sanyo, a big electronics company—admitted its accounting practices were under investigation. By then PricewaterhouseCoopers had lost faith in its Japanese affiliate. Its reputation in tatters, Misuzu has imploded just as Arthur Andersen did in America after the Enron scandal in 2001.

As for Nikko Cordial, it has also swayed on its feet of late. The TSE was considering its delisting, at which point America's Citigroup made advances. Perhaps thinking the prospect of foreign control was humiliation enough for the broker, the TSE on March 12th ruled that a delisting would be too harsh a punishment. That led to a bounce in Nikko's shares and Citigroup had to raise its offer, valuing the firm at $13.4 billion. The American giant has long looked for a way to expand into Japan's securities business. If its bid is successful—Citigroup's tender offer runs until the end of April—it would be the biggest-ever foreign acquisition of a Japanese securities firm.

With so many scandals, regulators are under pressure, despite earlier attempts at better supervision. One regulator complains that the FSA lacks a range of appropriate sanctions in cases like ChuoAoyama's, where auditors have clear management shortcomings. The authority can issue what the regulator calls the “popgun” of a public warning, or it can use the “cannon” of a suspension, from which the firm's reputation

may never recover. It has little in-between.

Earlier this month the FSA submitted a draft bill revising Japan's law dealing with auditors. The revision would impose fines on auditing firms when employees are found to have overlooked clients' falsified accounts. The FSA is also seeking powers to impose business-improvement orders on auditors, in the hope that problems can be picked up at an earlier stage.

Clearer roles as well as new tools may be what the regulators need now. The FSA and the Securities and Exchange Surveillance Commission that sits under it lack resources and independence. The Certified Public Accountants and Auditing Oversight Board, which also sits under the FSA, is both the accountants' watchdog and their representative. Crucially, Japanese companies are not obliged, as are American ones, to have oversight boards, independent of management, to select auditors and negotiate their fees. The relationship between auditors and their clients is dangerously cosy. What else might they be hiding between them?

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Economics focus

A stitch in time saves nine

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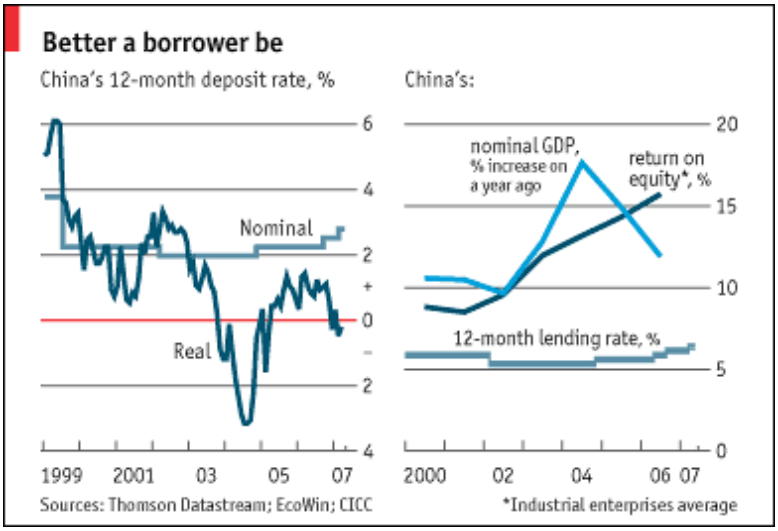
Chinese interest rates are still far too low

MOST central banks change interest rates by a quarter point here or a half point there. But the People's Bank of China (PBOC) is more particular. On March 18th, it raised its benchmark deposit and lending rates by precisely 0.27 percentage points, to 2.79% and 6.39% respectively.

Such fine calibrations may date back to the use of the abacus, and to an old Chinese convention that assumes a 360-day year for the purpose of reckoning interest payments. To make it simpler to calculate daily rates, lenders set annual rates that could be easily divided by 360. In practice this meant they had to be “divisible by nine” (because anything is easily divided by 40).

Even without an abacus, it is easy to show that Chinese interest rates are still surprisingly low. Despite the recent increase, the world's fastest-growing economy pays savers one of the world's lowest rates of interest. The ceiling of 2.79% on 12-month deposits barely compensates them for consumer-price inflation, which rose to 2.7% in February. Some economists reckon inflation could hit 3% in March, implying that the real rate of interest is probably still negative (see left-hand chart).



The rates paid by borrowers are higher, but not by much. The central bank's benchmark lending rate is above inflation in corporate-goods prices, now running at 4.5%. Even so, it looks far too low. In theory, a country's equilibrium interest rate should equal its marginal return on capital. In developed economies this is often taken to mean that interest rates should be roughly the same as the trend rate of GDP growth (a proxy for the return on capital). But China's nominal growth rate and its return on capital are both in double digits, well above the bank lending rate (see right-hand chart).

This is not to say that China's interest rates should be as high as 13% or so, in line with its nominal growth. Many other Asian emerging economies also have interest rates well below their growth rates, thanks largely to high levels of domestic saving. But, according to Jiming Ha, the chief economist at China International Capital Corporation, nowhere is the gap between the pace of growth and the rate of interest as wide as it is in China.

Mind your Ps and Qs

Central bankers can conduct monetary policy by changing either the price of money, ie, interest rates, or its quantity. In developed economies they favour interest rates. In China rate changes are less common: the latest move was only the fourth in three years, a period during which America's Federal Reserve has raised rates 17 times. China has relied more on quantitative measures, such as direct controls on lending and changes in the amount of reserves that banks must hold at the central bank. The PBOC's reserve-requirement ratio has been raised five times since July 2006.

One reason for this approach is that the economy has traditionally not been very sensitive to interest rates. Higher borrowing costs deter private-sector companies, but do not discourage inefficient state-owned enterprises, because they are less bothered about their return on capital. In such circumstances, direct controls on credit may have been a more effective way to curb overinvestment.

But leaving rates so low has its costs. Firms may borrow too much to invest in projects with low returns, thereby exposing banks to dangerous risks. Cheap loans encourage an overdependence on bank lending and hinder the development of capital markets. At the moment the most worrying distortion is that the low return on bank deposits is fuelling asset-price bubbles as households seek higher returns by buying shares and property. After plunging by 9% on February 27th, the Shanghai stockmarket has since rebounded past its previous high.

Higher reserve requirements have also lost their bite. In theory, if banks are required to hold more money on deposit with the central bank, this should increase the cost of their funds and so lead them to push up their interest rates. But banks' deposits at the PBOC are already much larger than the required ratio, so an increase does little to constrain their ability to lend.

China's monetary policy is also constrained by its rigid exchange-rate regime. Thanks to its widening trade surplus and strong inward investment, the country has experienced heavy inflows of foreign exchange, which swell domestic liquidity. The central bank has been reluctant to raise rates for fear this would attract more “hot money” from abroad. To regain control over its monetary policy, China needs a more flexible exchange rate.

A new IMF working paper* by Bernard Laurens and Rodolfo Maino argues that interest rates need to play a much bigger role in China's monetary policy. If the PBOC adopted a short-term money-market rate as its operational target, its policy would be more effective and the allocation of capital would be more efficient. The PBOC should scrap its controls on lending and deposit rates. It should also reduce banks' excess reserves to give them an incentive to borrow from each other in the interbank market, thereby enhancing the importance of money-market rates.

More controversially, the authors argue that the PBOC must be given full discretion to change interest rates. At present the State Council must approve all adjustments. The Chinese government is unlikely to grant the central bank such powers in the near future. Nonetheless, the PBOC should use all of its existing powers of persuasion to argue more strongly for higher interest rates now.

Even when free of political meddling, central banking is fraught with uncertainty. Monetary policymakers have to rely on good luck as well as sound judgment. That may be another reason why Chinese interest rates are divisible by nine: it is seen as an auspicious number. The Forbidden City in Beijing, for example, has 9,999 rooms. Unfortunately China's loose monetary policy is leaving rather too many hostages to fortune.

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* “China: Strengthening Monetary Policy Implementation”, IMF Working Paper No 07/14

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The Marjorie Deane internship

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Applications are invited for the 2007 Marjorie Deane internship. This award, financed by the Marjorie Deane Foundation, is designed to provide work experience for a promising journalist or would-be journalist, who will spend three months of the summer at *The Economist*, writing about economics and finance. Applicants may also be considered, if they wish, for an internship of similar duration at *CFO Europe*, a sister publication of *The Economist*. Applicants should send a letter introducing themselves, with an original article of no more than 650 words that they think would be suitable for publication in this section of *The Economist*. Applications should be sent by e-mail to deaneintern@economist.com or posted to the Business Affairs Editor (Deane internship), *The Economist*, 25 St James's Street, London, SW1A 1HG. They must reach us by April 13th.

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Malaria

A shift of perspective

Mar 22nd 2007
From The Economist print edition

Recruiting mosquitoes to fight malaria

Get article background

MAKING an ally out of an enemy is often a good policy. And that is what Mauro Marrelli and Chaoyang Li of Johns Hopkins University are trying to do. Until recently, *Anopheles*, the mosquito that spreads malarial parasites, has been seen by those trying to eradicate the disease as a target. Now, a few far-sighted researchers see it as an opportunity.

Science Photo Library

Your friendly, neighbourhood ally

The idea put forward by these researchers, Dr Marrelli and Dr Li among them, is to break the chain of transmission by breeding mosquitoes that are themselves resistant to malarial parasites, and then to take the genes that confer this resistance and establish them in the wild. The first bit of this strategy is not too difficult; several resistance genes have already been found. It is the second part that seems ambitious for, in order to get these genes to spread through the *Anopheles* population of Africa and other infected areas, they will have to confer higher fitness on the insects that contain them than is found in the natural population. But, in a paper just published in the *Proceedings of the National Academy of Sciences*, Dr Marrelli and Dr Li describe an experiment which suggests that this may, indeed, be possible.

Dr Marrelli and Dr Li are part of a group which has already discovered a gene that protects mosquitoes from malaria. The gene in question, called *SM1*, encodes a small protein that stops malarial parasites from getting through a mosquito's gut, thus preventing infection. The question is, at what cost? Other genes that protect against the parasite do so by stimulating the insect's immune system. That works, but imposes a burden on the animal, since materials and energy have to be diverted to the boosted immune system. In practice, such insects are worse off than they would be without the gene. But because *SM1* prevents infection rather than suppressing it, Dr Marrelli and Dr Li hoped that different rules might apply.

Unnatural selection

And so, it seems, they do. The two researchers and their colleagues took a mixture of “wild type” mosquitoes and those that had had *SM1* added to their genomes and fed them on mice infected with malarial parasites. The genetically modified beasts did better.

To make absolutely certain, the team used two different strains of parasite in different groups of mice. One strain was a type that, in any circumstances, only breeds in mammals, not insects. The other can breed in both. The upshot was that in mosquitoes fed on the mice carrying the mammalian parasite, the *SM1* gene had no advantage. In mosquitoes fed on the other group, though, it spread rapidly. By the ninth generation, 70% of the insects were carrying it. So, not only is *SM1* protective, it has a clear evolutionary advantage over the wild type, at least in the cosseted conditions of the laboratory.

It is, of course, a long way from the laboratory bench to the stagnant pool, and many questions remain. There is first a question of principle—namely whether it can ever be sensible to release genetically modified organisms to achieve an end like this. But there are also practical questions. One is why *SM1* did not sweep the population completely. This is probably because the gene helps when only one copy is present, but hinders when there are two, one from each parent. However, the details are unclear. Another practical point is that the type of malarial parasite used in this and many other experiments is not actually one that causes human disease. Just as researchers use mice to model human physiology, so they use this parasite, *Plasmodium berghei*, to model the lethal *Plasmodium falciparum*. Nevertheless, Dr Marrelli and Dr Li have produced a noteworthy result. The idea that helping mosquitoes, rather than destroying them, may be the way to eradicate malaria is pleasingly counterintuitive, even if it would mean more mosquito bites at night.

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Evolution

Darwin's rotifers

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An obscure group of invertebrates casts light on how new species form

WHEN Charles Darwin opened his first notebook on the subject of how organisms change over time, the field was not even referred to as “evolution”. It was, rather, “the species problem”—in other words, how did life's variety arise? Darwin showed in detail how life changes over the course of time by the process of natural selection, but failed to explain how those changes can take different courses, dividing a species in two and thus multiplying the number of species.

The two main schools of thought about speciation that emerged in the 20th century to fill this intellectual vacuum can be summed up as “breeding defined” and “niche defined”. The former argues that the reason members of a species resemble one another is that they are constantly swapping genes. The latter says it is that they are all adapted to live in the same ecological niche. The two explanations are not mutually exclusive. But it is only by looking at an asexual group that the second can be tested independently of the first.

Few creatures—even bacteria—do without sex entirely, but bdelloid rotifers are among that minority. As far as anyone can tell, these microscopic freshwater animals have not exchanged genes, one with another, for 100m years. This asexuality seems to have arisen only once, yet biology recognises about 380 species of bdelloid. If these species are not defined by interfertility, which obviously they are not, are they real, or just the convenient conventions of taxonomists? If they are real, it provides one clear answer to the species problem. Which is why Tim Barraclough and his colleagues at Imperial College, London, spent three years collecting bdelloids from ponds and streams in Britain and Italy. The results of this international small-game hunt have just been published in *Public Library of Science Biology*.

Dr Barraclough and his team classified their trophies in three ways. One relied on the DNA sequence of a gene called cytochrome oxidase. The second applied the same method to another gene called 28S ribosomal DNA. The third used an anatomical technique—the dimensions of the mouthparts—that is also applied to the finches of the Galapagos Islands which, tradition has it, set Darwin thinking about the species problem in the first place.

One advantage of these three ways of classifying things is that the results of each can be quantified and processed statistically using a technique called cluster analysis. Doing so showed Dr Barraclough three things. The first was that the three variables clustered similarly, suggesting that they were accurate markers of ancestry. The second was that they clustered in a way that more or less agreed with the traditional taxonomy of the bdelloids. The third, and most significant, was that they clustered in a particular way. The clusters had what are known in the argot of the trade as deep roots. In other words, individuals within a cluster were very much more similar to each other than they were to those of other clusters. That, in turn, suggests something is acting to keep them that way, by eliminating intermediate forms.

Specific information

The only plausible candidate for that something is natural selection to fit particular niches. Different niches, having different requirements, result in different genes and different shaped mouthparts. Indeed, the team has one excellent example of this. Just as three sorts of body lice, specialised to be able to grasp different sorts of hair, live on humans, so water lice are host to two sorts of bdelloid. One sort live on the creature's legs, the other on its body. Dr Barraclough's classification shows that these two apparent species are, indeed, real and evolutionarily distinct, even though they share a host.

The niche model of speciation thus looks proved. That does not rule out a gradual drift to infertility as an additional explanation, but makes it possible that infertility is a consequence, rather than a cause of speciation. In that case, there is probably active selection against hybridisation, since hybrids will be neither one thing nor the other, and thus not fit for the niche. But that, best beloved, is a subject for a whole different research project.

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Philosophy and neuroscience

Posing the right question

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The neurology of morality is being explored

IT IS the hoariest dilemma in undergraduate moral-philosophy classes: how do you pick the lesser of two evils? Often the problem is posed as the runaway-railway-wagon paradox. Given a choice between deliberately pushing someone in front of the wagon, in order to slow it down sufficiently for five people further down the line to escape, and allowing the five to die that the one may live, what should you do? Conversely, given a choice of throwing a set of points so that the wagon will go down a line where it will kill only one person, as opposed to five down the other line, what should you do?

On the face of things, the outcomes are identical in both situations. Either one person dies or five do. But, whereas most people have no difficulty choosing which is better in the second case (to kill one rather than five), the first usually causes paroxysms of guilt. Moral philosophers have spent years discussing this paradox. It has, however, taken a team of neuroscientists, led by Michael Koenigs of the University of Iowa and Liane Young of Harvard University, to come up with at least part of the real answer.

Basic emotions, such as fear, are regulated in part of the brain called the limbic system. These emotions—along with the limbic system—are shared by all mammals. Social emotions such as compassion, shame and guilt, however, are confined to a small number of species, and are most strongly expressed in man. They are associated with a particular part of the prefrontal cortex, an area of the brain that is much bigger in humans than in other mammal species. Dr Koenigs, Ms Young and their colleagues suspected that the seat of the runaway-railway-wagon paradox lies in that specific part of the prefrontal cortex, known as the ventromedial prefrontal cortex (VMPC).

To test this idea, they looked at six people with damage to the VMPC on both sides of their brains. These people are known from other work to have poor social-emotional responses. The researchers compared the responses of these people to various moral dilemmas with those of a group whose brains were undamaged and a second group with equivalent damage in other parts of the cortex. All three groups were asked questions (including the runaway-railway-wagon paradox) that previous studies have shown fall either side of the divide between the obvious and the squirm-inducing. The researchers' hypothesis was that people with VMPC-damage would come to the utilitarian answer in difficult cases (push the guy in front of the wagon) more often than either of the other two groups. And that, as they describe in this week's *Nature*, was exactly what happened. In cases where the choice involved personally causing harm, even for good ends, destroying the centre of social emotion also destroyed what is regarded by most people as normal moral judgment.

Pinning down the location of this part of morality does not answer the more fundamental question of why it evolved the way it did. It does, however, assist the process of thinking about that question.

In these cases it seems that the decision on how to act is not a single, rational calculation of the sort that moral philosophers have generally assumed is going on, but a conflict between two processes, with one (the emotional) sometimes able to override the other (the utilitarian, the location of which this study does not address).

That fits with one of the tenets of evolutionary psychology—a field which, as its name suggests, seeks to explain, rather than merely describe, mental processes. This is that minds are composed of modules evolved for given purposes. Dr Koenigs and Ms Young have shown that the VMPC may be the site of a “moral-decision” module, linked to the social emotions, that either regulates or is regulated by an as-yet-unlocated utilitarian module.

This does not answer the question of what this module (what philosophers would call “moral sense”) is actually for. But it does suggest the question should be addressed functionally, rather than in the abstract.

Time, perhaps, for philosophers to put away their copies of Kant and pull a dusty tome of Darwin off the bookshelf.

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Higher mathematics

Truth and Lies

Mar 22nd 2007
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Mapping the most complex known mathematical object

FOR more than a century mathematicians have known about Lie groups. These are families of shapes named after Sophus Lie, a Norwegian mathematician who discovered them. There are four “simple” families of Lie groups and five others—this being mathematics—that are not quite so simple.

The simplest member of the simplest Lie group is the circle, which looks the same however it is rotated. Its higher-dimensional cousin, the sphere, has the same properties, only more so, and is thus the second-simplest of the same family. The five non-simple groups—dubbed “exceptional” in their complexity and symmetry—are harder to envisage and, for almost 120 years, the details of the most intricate of these have lain beyond reach. This week a group of mathematicians led by Jeffrey Adams of the University of Maryland announced that they had completed a map of the largest and most complicated one, a structure known to mathematicians as E{-8}.

Lie groups have two defining features: surface and symmetry. A sphere has two surface dimensions. In other words, any place on its surface is defined by just two numbers, the longitude and the latitude. But it has three dimensions when it comes to symmetries. A sphere can spin on an axis that runs, say, from north to south, or on each of two axes placed at right angles to this. E{-8} is rather more difficult to visualise. Its “surface” has 57 dimensions—that is, it takes 57 co-ordinates to define a point on it, and it has 248 axes of symmetry.

Grappling with such a structure is as tricky as it sounds. But Dr Adams's team decided to have a go. They want to create an atlas of maps of the Lie groups. This involves making a description in the form of a matrix for each structure. (A matrix is a multi-dimensional array of numbers, such as that found in a sudoku puzzle.)

Dr Adams and his colleagues began by writing a computer program that would generate such matrices, a task that took them more than three years. It transpired that they needed 453,060 points to describe E{-8} but that they also needed to express the relationship between each of these points. That meant they had to devise a matrix with 453,060 rows and the same number of columns. In total this gives 205 billion entries. To complicate things further, many of these entries were not merely numbers but polynomials—sequences in which a given number is raised to a series of different powers, for example its square and its cube.

Processing such a vast quantity of data was beyond the capacity of even modern supercomputers, so the team were forced to tinker with the problem to make it tractable. This tinkering led them to a piece of ancient maths known as the Chinese remainder theorem.

This theorem is contained in a book written in the late third-century AD by a mathematician called Sun Tzu (not to be confused with the military strategist of the same name). It is used to simplify large calculations by breaking them down into many smaller ones, the results of which can then be recombined to generate the answer to the original question.

One problem addressed in the original book concerns counting soldiers. Sun Tzu's solution was that the soldiers should first split into groups of three, then groups of five, then groups of seven, with the number unable to join a group (in other words, the remainder) being noted each time. The three remainders can then be used to calculate how many soldiers are present. For example, if two were left over from the groups of three, three left over from the groups of five and two left over from the groups of seven, there would have been 23 soldiers in the unit (or possibly 233, but the difference should be obvious to even the stupidest commanding officer).

The researchers worked out how to use the remainder theorem to bring their calculation within the capacity of a supercomputer called Sage, which spent more than three days crunching the numbers to generate the map of E{-8}. Not content with letting the supercomputer do all the arithmetic, the mathematicians simultaneously jotted down some calculations of their own on the back of an envelope. They worked out that if each entry in the matrix were written on paper that was one inch square, the answer would cover an area the size of Manhattan.

And the point is

Apart from the satisfaction of mapping E{-8} at long last, mathematicians are pleased because the structure keeps popping up in another branch of intellectual endeavour: string theory. This purports to be the best explanation of the universe beyond the Standard Model of physics that describes all known particles and forces, but which is generally acknowledged to be incomplete. String theory requires that the universe has many more dimensions than those that are obvious, but that most of these extra dimensions are too small to be discerned with today's equipment. One of the ways in which they can be hidden involves E{-8}, so having a mathematical map of its structure could be handy. Cheaper, too, than building a particle accelerator the size of the solar system.

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The future of books

Not bound by anything

Mar 22nd 2007 | MOUNTAIN VIEW, CALIFORNIA
From The Economist print edition

Now that books are being digitised, how will people read?

Daniel Pudles

IN SECRET locations and using secret methods, human beings are scanning lots and lots of books for Google, the world's largest web-search company. That humans are involved is beyond doubt (fingers are visible in the corners of many pages on books.google.com) although this is uncharacteristic of Google, which has a fetish for purist technology.

Google will not divulge exact numbers, but Daniel Clancy, the project's lead engineer, gives enough guidance for an educated guess: Google's contract with one university library, Berkeley's, stipulates that it must digitise 3,000 books a day. The minimum for the other 12 universities involved may be lower, but the rate for participating publishers is higher. So a conservative estimate has Google digitising at least 10m books a year. The total number of titles in existence is estimated to be about 65m.

Google's is not the only project of its kind. The Internet Archive, for instance, is a non-profit organisation founded in 1996 by Brewster Kahle, a San Francisco idealist who wants to re-create a modern Library of Alexandria containing all public-domain texts and videos. Amazon has been scanning books, as have Microsoft and Yahoo!, Google's biggest rivals in web-search, and individual libraries around the world. Eager not to be left out, publishers are also doing the same. But Google's effort, in scale and ambition, is off the charts.

As books go digital, new questions, both philosophical and commercial, arise. How, physically, will people read books in future? Will technology “unbind” books, as it has unbundled other media, such as music albums? Will reading habits change as a result? What happens when books are interlinked? And what is a book anyway?

Change is least likely in the physical medium of books. Electronic books do exist; the best-known is the Sony Reader, a book-sized gadget made by the eponymous consumer-electronics company. Sony currently makes 12,000 books available online for download, but “our mission is not to replace the print book,” says Ron Hawkins, the Sony Reader's marketing boss.

There is an obvious analogy between what Apple's iPods have done to CD players and what electronic books may do to the printed page, but the shift is unlikely to be quite so comprehensive. The simplest

difference is that transferring one's old music CDs onto iPods is easy, whereas transferring one's old books onto an e-book is impossible.

So who is going to read the millions of pages that Google and its colleagues are so busy digitising? Some people will read them on-screen, some will use Google as a taster for books they will then buy in paper form or borrow from a library, and still more will use it to look for specific snippets that interest them.

The biggest changes are likely to be seen in what becomes a book in the first place. Here the internet may indeed be to some book genres what Apple has been to music or what YouTube (now part of Google) has been to video. Among younger listeners albums are dead. They have been replaced by playlists of individual songs designed to be shared with friends.

In books this has already happened for encyclopedias. Wikipedia, which is free, collaborative and online, has eaten into sales of paper-bound alternatives. So books that people would not traditionally read in their entirety, or that require frequent updating, are likely to migrate online and perhaps to cease being books at all. Telephone directories and dictionaries, and probably cookbooks and textbooks, will all fall into this category.

With non-fiction the situation is more nuanced. Many non-fiction books express an intellectual idea. Traditionally, the only way to deliver such an idea profitably involved binding it into a 300-page book, says Seth Godin, a blogger and author of eight books on marketing. “If you had a 50-page idea, you couldn't make any money from it,” he says, so a lot of non-fiction books end up on shelves with 250 unread pages. Freedom from such rigidities may save a lot of authorial time.

Non-fiction books will also benefit from another change that comes with digitisation. Like web pages, digitised books can have incoming and outgoing hyperlinks. On books.google.com at the moment, links are only to entire books. But in future, says Google's Mr Clancy, links will point to and from specific phrases or words inside books. Footnotes, citations and bibliographies are obvious points for live links.

This has several benefits. It will help scholarly research, since it makes primary sources much more accessible. And it will reduce the slog of academic book-worming—jotting down the location of a book, trudging through the library, pulling it off the shelf, queuing for the photocopier—to the negligible effort of clicking a mouse.

Such links will also make books much easier to discover, by helping search engines. As link structures develop around books, search algorithms can count incoming links as “votes”, giving more weight to incoming links from much-cited places and less to obscure ones. The (offline) citation culture of academic literature already works this way. This, in fact, is what gave Larry Page, one of Google's co-founders, the original idea for his search algorithm, which he cheekily called PageRank.

What about all the genres of books that fill a different human need? Certainly, some types of fiction—novels as well as novellas—are also likely to migrate online and to cease being books. Many fantasy fans, for example, have already put aside books and logged on to “virtual worlds” such as “World of Warcraft”, in which muscular heroes and heroines get together to slay dragons and such like. Science fiction may go the same way, and is arguably already being created by “residents” of online worlds such as Second Life.

Most stories, however, will never find a better medium than the paper-bound novel. That is because readers immersed in a storyline want above all not to be interrupted, and all online media teem with distractions (even a hyperlink is an interruption). People do not read fiction in order to accomplish a specific task in a limited amount of time, as they read reference and schoolbooks. Random-access dictionaries and cookbooks may be useful; random-access novels less so.

What about short stories and poems? Being short, they fit the new media, so some may do well online and need not be bound in paper. Commuters could receive their daily *haiku* or sonnet on their mobile phones while taking the bus to work. They might also use the new media to enjoy poetry in a more traditional way. “Storytelling started as oral history,” says Adam Smith, the boss of Google's book project, so a partial reversion to that form, through podcasting, would be natural.

But even anthologies of short stories and poems, like longer novels, are unlikely to disappear. People want to be guided by others. They also want media suitable for unhurried reading in beds and bathtubs and on beaches. Above all, they want paper books for what digitisation is revealing them to be. Books are not primarily artefacts, nor necessarily vehicles for ideas. Rather, as Mr Godin puts it, they are “souvenirs of the way we felt” when we read something. That is something that people are likely to go on

buying.

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About sponsorship

Ireland from 1939 to 1945

The power of neutrality

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A CARTOON dated about 1944 shows two Irishmen operating the tail gun in an RAF bomber over Germany, heavy flak outside. “One thing you can say about Dev”, says one to the other, “is he kept us out of the war.”

“Dev” is Eamon de Valera, prime minister of Ireland, who ostentatiously declared the country's neutrality in 1939 at the outbreak of the second world war. But Clair Wills argues that neutrality did not prevent the recruitment of a large force of Irish men and women, who, like the tail gunners, saw no contradiction between their country's neutrality and their own involvement in the war.

Ms Wills suggests that 150,000 Irish people served in the British armed forces, though that could be a rough total from all Ireland: the Foreign Office now says there were 50,000 Irish servicemen, maybe more. Whichever is correct, the number was either substantial or very substantial. Many Irish civilians also worked in Britain. Again, no one knows just how many; estimates vary from 120,000 to 300,000, or as many as one in ten of the entire population. More than 25,000 Irish building workers were recruited by Sir Robert McAlpine, a British construction company, and without them the delivery of new airfields for the RAF and the Mulberry harbour built at Arromanches in Normandy for the D-Day landings would have been dangerously delayed.

That Neutral Island: A Cultural History of Ireland During the Second World War
By Clair Wills

Faber and Faber; 352 pages; £25. To be published in America by Belknap Press in September

Buy it at Amazon.co.uk

The independence of the 26 counties of southern Ireland had been confirmed as recently as 1937, and de Valera was unwilling to surrender an ounce of Ireland's new-won sovereignty merely to fight the Nazis. Ms Wills is sympathetic: “If neutrality was dangerous, belligerence looked like suicide.”

She observes the Irish situation through the writings of Elizabeth Bowen and her lover Sean O'Faolain, Louis MacNeice and Flann O'Brien, as well as through politics. Even now, the politics seem more interesting. The immediate consequences of Irish neutrality were the loss of British naval access to the three Treaty ports in the south. Sir Winston Churchill furiously blamed the loss of 1,000 ships in 1940 on de Valera's intransigence. Eventually, the navy developed new bases in the north of Ireland, and losses fell when the convoys were re-routed. Unlike Dublin—where a total of 32 lives were lost as a result of a German bomber's navigational error—Belfast suffered terribly from bombing. Neutrality did not, however, stop the Dublin fire brigade from dashing north to help out.

Neutrality meant that charitable ladies in Killarney were questioned by *gardai* for daring to supply wool for socks and scarves for both Irish and British troops. Censorship and detachment made it difficult for Irish people to respond to the Holocaust or the nuclear bombing of Hiroshima. Shortages forced farmers off the land, quite contrary to de Valera's philosophy. Tea, flour and sugar were scarce, but visitors from the rest of Britain noticed only the absence of rationing. “The shops are full of good things, the streets full of people who cannot afford to buy them,” Cyril Connolly noted.

To the English, the Irish remained baffling. Neutrality meant, for instance, that de Valera felt compelled to offer condolences at the German embassy in Dublin on Hitler's death in 1945. (“The best-known event in Ireland's wartime history,” notes Ms Wills.) By then the Irish had persuaded themselves that they were properly independent, even if they did live and work in Britain. It was an unromantic, sometimes grubby episode in the history of Irish nationalism, but they had done something rare—they had had their cake and eaten it.

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Russia's bloody wars

Small state seeks new history

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CHECHNYA is a rebellious part of Russia that was run by gangsters and Islamic fundamentalists, closely linked to al-Qaeda. After a bloody but necessary war, it has become largely peaceful though occasional terrorist attacks continue.

Reuters

Washing away history

Chechnya: The Case for Independence
By Tony Wood

Verso; 199 pages; $22.95 and £12.99

Buy it at
Amazon.com
Amazon.co.uk

That, roughly, is what the Kremlin would like the world to believe. Tony Wood's new book takes issue with every part of that argument and puts the case, in a simplistic if passionate manner, for the other side. The truth, he maintains, is that the outside world's “credulousness and cowardice” has enabled a “chilling conjuring trick”, in which the Chechens' aspirations to self-determination have disappeared behind a “cloud of euphemisms and falsifications”.

For a start, Chechnya is not legally part of Russia. It was part of the Soviet Union, true, but it gained the rights of a “republic”, including the right to determine its own future, from the Soviet parliament in 1990. That put it, Mr Wood argues, on broadly the same legal footing as other “Soviet republics” such as Estonia or Ukraine. When the Soviet Union collapsed, Chechnya did not vote to join its successor state, the Russian Federation. The agreements that ended the first Chechen war in 1996 explicitly recognised the republic as a subject of international law.

Mr Wood, assistant editor of *New Left Review*, a British periodical, concedes that the period of semi-independence that followed was a grisly mess, where kidnapping and slave-trading became big business. But he blames Russia for that, for having ruined the Chechen economy and for the Kremlin's persistent attempts to undermine the Chechen authorities.

He argues strongly against the idea that Chechnya was or is an outpost of international Islamic terrorism. Saudi-financed extremism was alien to the Sufi and nationalist traditions of Chechen Islam, he says, and the ties that have arisen are opportunistic, not ideological. Reports of Chechens fighting abroad have been grossly exaggerated; so have the numbers of foreign fighters in Chechnya.

The wars in Chechnya have been atrocious on both sides. While condemning the “degeneration” of Chechen resistance tactics into terrorism, Mr Wood tries hard to depict them as reactions to the systematic and continuing use of illegal detention, torture, rape and murder by the Russian side. Far from pacifying the republic and restoring normal life, the Kremlin has installed a “vicious client regime”

that rules by “larcenous brutality”.

Chechnya has often been a pawn in Russia's internal power-struggles and related swindles, and Mr Wood is right to highlight the Kremlin's cynicism, incompetence and casual brutality. But the book is too slim, simplistic and one-sided to do full justice to the issue. Russians come across as cardboard villains, with no hint of the agonised debates and dilemmas the war has prompted. Equally, he depicts the Chechens as cardboard martyrs, not real people with spectacular virtues and failings. The reader gets little flavour of Chechnya's steamy clan politics, or the rebel leadership's often bizarre and batty notions, nor of the murky deals in which all sides are engaged.

Chechnya: The Case for Independence.
By Tony Wood.
Verso; 199 pages; $22.95 and £12.99

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The fate of coral

Not just a pretty polyp

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From The Economist print edition

IF YOU thought coral was just a basic form of rather pretty underwater life, think again. The diminutive reef-builders gave us oxygen to breathe, cooled the atmosphere down to a clement level and went on to build the only biological structure that is visible from space—the Great Barrier Reef.

But the symbiosis between a coral polyp and its resident algae is not glorious, says Steve Jones, professor of genetics at University College London and a well-known populariser of science. Instead, the union is full of "selfishness and suspicion". What is more, the blackness of life on the reef—a wearying series of catastrophes and cataclysms—is mirrored above the surface.

Mr Jones is true to his book's subtitle. Despite the common perception of coral islands as Utopias, he argues that before contact with the Western world they were full of cannibals and plagued by climatic uncertainty, and afterwards, their vulnerable populations became syphilitic and their shores infested with rats.

Coral: A Pessimist in Paradise
By Steve Jones

Little, Brown; 256 pages; £15.99

Buy it at
Amazon.co.uk

But the book is not all gloom. Despite his jaundiced eye, Mr Jones is an experienced, poetic pilot, steering an eccentric and surprising course through the intricacies of reef life and its implications. Through the book's five chapters the reader is led into the history of coral science, reef genetics, the philosophy of symbiotic existence, the chaos of undersea geology and the economics of carbon. But just as a good explorer should, Mr Jones ventures far and wide, with detours through stem-cell research, chaos theory, Greek mythology and sexual disease, as well as the diamond trade, before reaching his gloomy conclusion.

Charles Darwin pondered the formation of coral islands while travelling to the Galapagos on *HMS Beagle*. But it was only once he had actually set foot on an atoll that he was struck by his epiphany: coral islands had been grown by "insects" (as polyps were then known), not built by God. Mr Jones begins with the gripping tale of Darwin's tortuous quest to have his theory accepted and his eventual (and posthumous) vindication after a 1,411-metre-long coral core was extracted from the south Pacific and studied by scientists after the Bikini atoll nuclear tests

At the heart of every reef is the union between a coral polyp and its algae, and this prospect of mutual co-operation has enthralled philosophers from every walk of life. Both Beatrix Potter and a bright-eyed young Russian prince named Pyotr Alekseyevich Kropotkin found the metaphor irresistible, as did the indomitable Karl Marx, who said, "We see mighty coral reefs rising from the depths of the ocean into islands and firm land, yet each individual depositor is puny, weak and contemptible."

As coral grows it records details of the climate just as tree rings do on land and so tells tales of oceanic uncertainty, tsunamis and El Niño. "The reefs themselves make some firm, and sombre, predictions about our own apocalypse," Mr Jones concludes. These colourful coral Utopias, he believes, are now doomed. Human ingenuity revealed the intricate workings of coral reefs, but it has also spelled their ruin.

Coral: A Pessimist in Paradise.
By Steve Jones.
Little, Brown; 256 pages; £15.99

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About sponsorship

Contemporary dance

Point man

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Renowned for his confrontational artistic style, Israeli-born Itzik Galili is rapidly becoming one of Europe's most interesting and unusual choreographers

Karel Zwaneveld

ITZIK GALILI really is an artist of the floating world. Born in Israel in 1961, he moved to Amsterdam when he was 30 and is shaping up as one of Europe's most idiosyncratic choreographers. Mr Galili holds dual Israeli and Dutch citizenship. He has three children in Israel and visits them every ten days. In addition to his native Hebrew, he also speaks good English and Dutch.

Mr Galili is highly regarded in the Netherlands. Marking the tenth anniversary of the founding of his company, Galili Dance, a new show, “Heads or Tales”, has been receiving enthusiastic reviews as it tours the country. Fiercely contemporary, “Heads or Tales” is full of gorgeous imagery, compelling ensemble work and arresting solos. One thing it is not, though, is balletic. Scenes include a naked man being showered with bits of paper, men doing the pogo, and a man and woman engaged in tentative ballet while conducting a dialogue about genocide.

Mr Galili's artistic style is confrontational: athletic, unsentimental and often witty. He claims not to be specifically political, believing that politics and choreography rarely sit well together. But in “For Heaven's Sake”, a powerful piece that he first staged in 2001 and which he revised last year, the images of occupation—conjuring up the Israelis in Palestine, perhaps, or the Americans in Iraq—could not be mistaken for anything else.

Ten years ago, Mr Galili moved from Amsterdam to the northern town of Groningen. A friend had called, urging him to apply for a position there as director of dance. Mr Galili got the job. Groningen is a pleasant place, with an old university, but its claims to fame do not extend to much beyond the industrial processing of sugar-beet and a glorious 15th-century tower. “Who would want to go to Groningen?” asks Mr Galili with an ironic smile.

Yet in many respects it was a shrewd move. For such a small country, the Netherlands has an unusual quantity of world-class dance troupes, including the Dutch National Ballet, based in Amsterdam, and the more experimental Netherlands Dance Theatre (NDT) in The Hague. Both fill theatres across the globe.

In Groningen, though, Mr Galili is dance's top dog. That allows him to work with a freedom and intensity that he might not be permitted were he competing with a bigger troupe in a major urban centre. One

measure of Galili Dance's status is the number of young hopefuls who want to join. The full tally of its performing employees amounts to only ten people. Yet once or, at most, twice a year, Mr Galili sees between 350 and 500 applicants over three days each time.

Small, for Mr Galili, is clearly beautiful. His thinking about dance is correspondingly original. Talent, even if discernible from an early stage, develops only slowly. Almost everything begins in improvisation, and his aim is never merely to make an audience laugh or cry. There must always be a journey “within”, he says.

Mr Galili knew nothing about dance until he was in his early 20s. He had had a disrupted childhood, with his parents divorcing and his mother suffering a breakdown. He and two other siblings were fostered by three different families, and Mr Galili recalls with evident pain that he grew up in 17 different places between the ages of five and 18. After doing his military service in Israel in the early 1980s, he caught the dance bug when watching five men dancing to a Greek folk tune; he had always loved Greek music.

Then, in one of the more bizarre twists in this itinerant choreographer's tale, Mr Galili learnt how to cut and shape poodles' hair for rich poodle-owners. Using this new-found talent, he made money fast, and was able to finance further dance studies in Tel Aviv and Guildford, south-west of London. Mr Galili subsequently worked with two well-known Israeli troupes, the Bat-Dor and Batsheva Dance companies. “I miss Israel madly when I'm not there, but an artist can, in my view, work anywhere.” Mr Galili may not realise quite how much Israel has influenced his dance, but like his native land, it is defiant, extrovert and very tough.

Galili Dance is touring the Netherlands until May, after which it goes to Spain

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About sponsorship

Preah Maha Ghosananda

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Preah Maha Ghosananda, “the Gandhi of Cambodia”, died on March 12th, aged 78

AFP

ASIA'S great spiritual leaders tend to build shrines round themselves. There they sit, disciples at their feet, handing down instructions for achieving the perfect life. When Preah Maha Ghosananda, in later years, became associated with Buddhist temples in Rhode Island and Massachusetts, his admirers would expect to find him there. He seldom was. He would be far away, walking.

Where he walked was often remote, but it was neither safe nor quiet. He would tread, a little bird-like man with hands folded and head bowed, along narrow paths that threaded through the jungle-forests of central Cambodia. Care was necessary, for the ground had been sown with landmines up to the edge of the trails. Humidity would mist his glasses and slick his bald head with sweat. His orange monk's robes, hitched up to show stout boots and socks, would tangle in the bushes. Behind him, chanting to the beat of a drum, would stream 200-300 laymen, monks and nuns, walking across Cambodia for peace.

Though Ghosananda led these *Dhammayietra*, or “Pilgrimages of Truth” in the early 1990s, well after the signing of peace accords to end a civil war between the remnants of the murderous Khmers Rouges and the new, Vietnamese-backed Cambodian government, he often found war still raging. Shells screamed over the walkers, and firefights broke out round them. Some were killed. The more timid ran home, but Ghosananda had chosen his routes deliberately to pass through areas of conflict. Sometimes the walkers found themselves caught up in long lines of refugees, footsore like them, trudging alongside ox-carts and bicycles piled high with mattresses and pans and live chickens. “We must find the courage to leave our temples”, Ghosananda insisted, “and enter the suffering-filled temples of human experience.”

Many of the villagers they met had not seen a Buddhist monk for years. In the old Cambodia, before the Khmers Rouges in April 1975 had proclaimed a new Utopian era, “forest-monks” had been a part of rural life, wandering through with staves and bowls, exchanging a handful of rice for a blessing. Now, though the Khmers Rouges had outlawed nostalgia, had razed the monasteries and thrown the mutilated Buddha-statues into the rivers, old habits stirred. As they caught Ghosanada's chant, “Hate can never be appeased by hate; hate can only be appeased by love”, soldiers laid down their arms and knelt by the side of the road. Villagers brought water to be blessed, and plunged glowing incense sticks into it to signal the end of war.

Ghosananda himself had missed the horrors of the Khmer Rouge years. His family, ordinary peasant folk from the Mekong delta, had been wiped out; monks like him, “social parasites” as they were now branded, were defrocked, forced to labour in the fields, or murdered. Out of 60,000 only 3,000 were left alive, and those had fled. But Ghosananda had gone to Thailand to learn meditation in 1965, staying for

years in a hermitage in the forest where only the buzz of insects disturbed him. Not until 1978, when he went to minister to Cambodian refugees in the camps on the Thai border, did he learn that Buddhism had been destroyed in Cambodia, although almost all the people had adhered to it. He decided then that his duty was to restore his country's sacred foundation.

Step by step

He did not believe this could be done through grand temples or enclosed institutions. Certainly he could have gone that way. Like many others he had been a *dek wat*, a “temple kid”, washing the monks' dishes and carrying their alms-bowls. Unlike others, he became a monk and remained one, getting all his education in temples and eventually gaining a doctorate in Pali, the scriptural language of Theravada Buddhism. He was a polymath and an intellectual. Yet he could not stay out of the world. Rather than devoting himself to monastic scholarship, he built hut-temples in the refugee camps and handed out dog-eared photocopies of the Buddha's *Metta Sutta*, or Words of Love:

> With a boundless heart
> Should one cherish all living beings:
> Radiating love over the entire world
> Spreading upwards to the skies,
> And downwards to the depths...

On his walks his message remained the same. It needed no complication. The work, he knew, would be slow: “step by step”, as he liked to say. It would continue as long as Cambodians felt divided from each other and brutalised by their past.

After 1980 he was made much of. He represented the Cambodian government-in-exile at the United Nations, and was influential in the peace talks; in 1988, he was made Supreme Patriarch of Cambodia. Several times he was nominated for the Nobel peace prize. He founded more than 50 temples across the world. Some he spoke at; but his first priority lay elsewhere. It was to appear, birdlike, out of the Cambodian forest, to surprise a man digging or a woman washing; to remind them that the power of love was stronger than the forces of history; and then to move on.

> For the pure-hearted one
> Having clarity of vision,
> Being freed from all sense desires,
> Is not born again into this world.

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Overview

Mar 22nd 2007
From The Economist print edition

China's central bank raised its benchmark lending rate by 0.27 percentage points to 6.39%, the third such increase in a year.

The **Federal Reserve** left interest rates at 5.25% at the conclusion of its two-day rate-setting meeting on March 21st. The Fed acknowledged that “the adjustment in the housing sector is ongoing” and removed its previous reference to a possible tightening of monetary policy. But it said its main concern was still “the risk that inflation will fail to moderate as expected.”

Consumer prices in **America** rose by 0.4% in February. Prices were 2.4% higher than a year earlier. Core inflation, which excludes the volatile prices of food and energy, was 0.2% in the month. Industrial production rose by 1% in February and was 3.4% higher than a year earlier. Housing starts rose by 9% in February, but were nevertheless 28.5% lower than a year earlier.

The **Bank of Japan** decided by unanimous vote to keep interest rates at 0.5%. The Bank says the immediate outlook is for inflation to stay at around zero, but that it expects positive inflation in the longer term.

In **Britain** consumer prices rose by 2.8% in the year to February, slightly faster than the 2.7% increase in the year to January. The minutes of the Bank of England's monetary policy committee meeting, released this week, revealed that one of its nine members voted for a reduction in interest rates on March 8th.

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Output, prices and jobs

Mar 22nd 2007
From The Economist print edition

Output, prices and jobs

% change on year ago

	Gross domestic product				Industrial production	Consumer prices			Unemployment
	latest	qtr*	2007†	2008†	latest	latest	year ago	2007†	rate‡, %
United States	+3.1 Q4	+2.2	+2.6	+2.9	+3.4 Feb	+2.4 Feb	+3.6	+2.3	4.5 Feb
Japan	+2.1 Q4	+4.8	+2.2	+2.3	+4.3 Jan	nil Jan	–0.1	+0.6	4.0 Jan
China	+10.4 Q4	na	+9.8	+9.7	+14.7 Dec	+2.7 Feb	+0.9	+2.7	9.8 2006
Britain	+3.0 Q4	+3.2	+2.7	+2.6	+0.4 Jan	+2.8 Feb**	+2.0	+2.0	5.5 Jan††
Canada	+2.3 Q4	+1.4	+2.4	+2.7	–3.3 Dec	+2.0 Feb	+2.2	+2.1	6.1 Feb
Euro area	+3.3 Q4	+3.6	+2.3	+2.2	+3.7 Jan	+1.8 Feb	+2.3	+1.9	7.4 Jan
Austria	+3.3 Q4	+3.3	+2.6	+2.5	+8.9 Dec	+1.7 Feb	+1.2	+1.8	4.5 Feb
Belgium	+3.1 Q3	+2.5	+2.1	+2.3	+4.4 Jan	+1.8 Feb	+2.4	+1.9	11.5 Feb‡‡
France	+2.2 Q4	+2.6	+2.1	+2.2	–0.6 Jan	+1.0 Feb	+1.9	+1.7	8.6 Jan
Germany	+3.7 Q4	+3.5	+2.2	+2.1	+7.9 Jan	+1.6 Feb	+2.1	+1.5	9.3 Feb
Greece	+4.3 Q4	na	+3.5§	+3.3§	+3.0 Jan	+2.7 Feb	+3.2	+2.8§	8.8 Q4
Italy	+2.8 Q4	+4.7	+1.8	+1.6	+1.3 Jan	+1.8 Feb	+2.1	+2.0	6.5 Q4
Netherlands	+2.7 Q4	+2.6	+2.7	+2.6	+4.6 Jan	+1.5 Feb	+1.1	+1.9	5.0 Feb††
Spain	+4.0 Q4	+4.8	+3.3	+2.8	+7.7 Jan	+2.4 Feb	+4.0	+2.8	8.6 Feb
Czech Republic	+5.8 Q4	+5.8	+5.1	+4.6	+9.8 Jan	+1.5 Feb	+2.8	+2.4	7.7 Feb
Denmark	+2.9 Q4	+0.6	+2.5	+2.3	+1.1 Jan	+1.9 Feb	+2.1	+2.1	3.8 Jan
Hungary	+3.2 Q4	+3.2	+2.3	+3.0	+10.5 Jan	+8.8 Feb	+2.5	+6.6	7.5 Jan††
Norway	+2.7 Q4	+2.0	+2.5§	+2.2§	–2.4 Jan	+0.8 Feb	+2.6	+2.6§	2.8 Jan††
Poland	+6.4 Q4	na	+5.4	+5.0	+12.9 Feb	+1.9 Feb	+0.7	+2.0	15.1 Jan‡‡
Russia	+6.5 Q3	na	+7.0	+6.3	+8.7 Feb	+7.8 Feb	+11.1	+7.3	7.1 Jan‡‡
Sweden	+4.7 Q4	+5.0	+3.5	+3.0	+4.1 Jan	+2.0 Feb	+0.6	+1.8	4.8 Feb‡‡
Switzerland	+2.2 Q4	+1.8	+2.1	+2.0	+8.2 Q3	nil Feb	+1.4	+1.2	3.2 Feb‡‡
Turkey	+3.4 Q3	na	+4.3	+5.3	+14.8 Jan	+10.2 Feb	+8.2	+8.3	9.6 Q4‡‡
Australia	+2.8 Q4	+4.2	+2.8	+3.2	+0.9 Q3	+3.3 Q4	+2.8	+2.6	4.6 Feb
Hong Kong	+7.0 Q4	+5.3	+5.4	+5.1	–1.4 Q4	+0.8 Feb	+1.2	+2.5	4.3 Feb††
India	+8.6 Q4	na	+8.0	+7.8	+10.9 Jan	+6.7 Jan	+4.7	+5.0	7.6 2006
Indonesia	+6.1 Q4	na	+6.0	+5.9	+23.4 Dec	+6.3 Feb	+17.9	+6.5	10.3 2005
Malaysia	+5.7 Q4	na	+5.5	+5.7	+2.3 Jan	+3.1 Feb	+3.2	+2.5	3.1 Q3
Pakistan	+6.6 2006§§	na	+6.6§	+6.0§	+6.8 Sep	+7.4 Feb	+8.0	+6.8§	na
Singapore	+6.6 Q4	+7.9	+5.4	+5.4	+14.6 Jan	+0.3 Jan	+1.8	+1.4	2.6 Q4
South Korea	+4.0 Q4	+3.4	+4.4	+4.7	+7.4 Jan	+2.2 Feb	+2.0	+2.3	3.2 Feb
Taiwan	+4.0 Q4	na	+4.3	+4.6	+4.8 Jan	+1.7 Feb	+1.0	+1.4	3.9 Feb
Thailand	+4.2 Q4	+2.7	+4.3	+4.8	+7.3 Jan	+2.3 Feb	+5.6	+2.9	1.0 Dec
Argentina	+8.6 Q4	+7.4	+7.0	+4.8	+2.2 Jan	+9.6 Feb	+11.5	+9.8	8.7 Q4‡‡
Brazil	+3.8 Q4	+4.5	+3.3	+3.5	+4.5 Jan	+3.0 Feb	+5.5	+3.7	9.3 Jan‡‡
Chile	+2.9 Q3	–0.2	+5.1	+5.2	+3.7 Jan	+2.7 Feb	+4.1	+2.6	6.1 Jan†††‡
Colombia	+7.7 Q3	+8.1	+5.0	+4.5	+12.3 Dec	+5.3 Feb	+4.2	+4.2	11.8 Dec‡‡
Mexico	+4.3 Q4	+1.9	+3.5	+3.7	+1.4 Jan	+4.1 Feb	+3.7	+3.8	4.0 Jan‡‡
Venezuela	+11.8 Q4	na	+6.2	+3.9	+4.1 Dec	+20.4 Feb	+12.5	+18.3	10.1 Q3‡‡
Egypt	+7.1 Q3	na	+6.5	+5.9	+4.0 2005	+12.6 Feb	+4.0	+9.9	10.9 Q2‡‡
Israel	+3.7 Q4	+8.0	+4.6	+4.3	+6.9 Jan	–0.8 Feb	+3.1	+1.4	7.7 Q4
Saudi Arabia	+4.2 2006§	na	+4.1§	+5.0§	na	+2.9 Dec	+1.2	+2.5§	na
South Africa	+6.1 Q4	+5.6	+4.4	+4.7	+6.2 Jan	+6.0 Jan	+4.0	+5.4	25.6 Mar‡‡
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*									
Estonia	+10.9 Q4	+8.2	+9.2§	+7.6§	+6.8 Jan	+4.7 Feb	+4.6	+4.3§	4.7 Jan
Finland	+5.3 Q4	+3.8	+2.7§	+2.5§	–3.2 Jan	+2.2 Feb	+0.9	+1.4§	7.0 Feb
Iceland	+2.5 Q4	+7.8	+2.8§	+3.7§	na	+5.9 Mar	+4.5	+3.9§	1.2 Dec‡‡
Ireland	+7.7 Q3	+10.8	+5.4§	+3.6§	+8.9 Jan	+4.8 Feb	+3.3	+3.4§	4.3 Feb
Latvia	+11.9 Q4	na	+9.2§	+7.5§	+0.2 Jan	+7.3 Feb	+6.1	+6.0§	6.1 Jan
Lithuania	+6.9 Q4	+7.4	+6.5§	+6.4§	na	+4.3 Feb	+3.4	+1.9§	6.2 Feb
Luxembourg	+5.4 Q3	+4.1	+4.3§	+4.8§	+2.3 Dec	+2.0 Feb	+3.0	+2.0§	4.9 Jan‡‡
New Zealand	+1.3 Q3	+1.0	+3.0§	+3.1§	–1.4 Q3	+2.6 Q4	+3.1	+2.0§	3.7 Q4
Peru	+9.2 Jan	na	+6.1	+5.5	+11.9 Dec	+0.4 Feb	+2.7	+1.4	11.6 Jan‡‡
Philippines	+6.5 Q4	+5.6	+5.6	+5.7	–9.2 Dec	+2.6 Feb	+7.6	+4.2	7.3 Q4‡‡
Portugal	+1.7 Q4	+1.9	+1.4§	+2.0§	+3.0 Jan	+2.4 Feb	+2.9	+2.4	8.2 Q4‡‡
Slovakia	+9.6 Q4	na	+7.0§	+5.4§	+17.5 Jan	+2.7 Feb	+4.4	+2.5	11.0 Jan
Slovenia	+5.5 Q4	na	+5.8§	+5.3§	+4.2 Dec	+2.1 Feb	+2.2	+2.7	8.7 Jan‡‡

*% change on previous quarter, annual rate. †The Economist poll. ‡National definitions. §Economist Intelligence Unit estimate/forecast. **RPI inflation rate 4.6% in Feb. ††Latest three months. ‡‡Not seasonally adjusted. §§Year ending June.

Sources: National statistics offices and central banks; Thomson Datastream; Reuters; Centre for Monitoring Indian Economy; OECD; ECB

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The Economist commodity-price index

Mar 22nd 2007
From The Economist print edition

The Economist commodity-price index

2000=100

	Mar 13th	Mar 20th*	% change on one month	% change on one year
Dollar index				
All items	190.6	194.7	+3.3	+25.1
Food	157.5	159.3	−0.3	+19.3
Industrials				
All	233.5	240.4	+6.5	+30.5
Nfa†	153.4	154.6	−1.1	+5.4
Metals	277.2	287.3	+9.0	+40.3
Sterling index				
All items	149.6	150.8	+3.2	+11.6
Euro index				
All items	133.5	135.4	+2.2	+13.8
Gold				
$ per oz	648.90	659.90	+0.4	+20.0
West Texas Intermediate				
$ per barrel	57.97	57.28	−1.7	−4.9

*Provisional †Non-food agriculturals.

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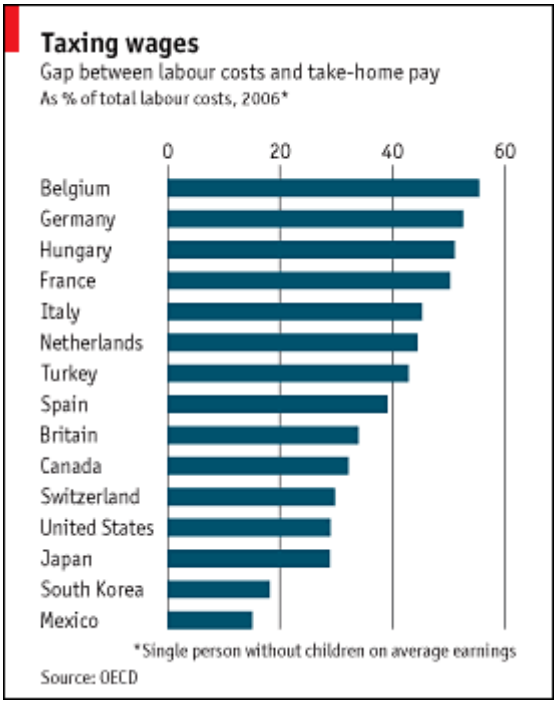
Taxing wages

Mar 22nd 2007
From The Economist print edition



The latest OECD survey of employment taxes looks at the "tax wedge"—the gap between what employers pay for labour and what employees take home as pay. The tax wedge is made up of income taxes and the social-security contributions of both firms and workers. The bigger the wedge, the greater are the barriers to job creation. Tax wedges are fattest in continental Europe, exceeding 50% of gross labour costs in Belgium, Germany, Hungary and France. South Korea and Mexico are the only OECD countries where the tax wedge is below 20%. Since the 2005 survey, the wedge has narrowed most in the Czech Republic, Finland, Ireland, Iceland and Australia. The largest increase by far was in the Netherlands.

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Trade, exchange rates, budget balances and interest rates

Mar 22nd 2007
From The Economist print edition

Trade, exchange rates, budget balances and interest rates

	Trade balance* latest 12 months, $bn	Current-account balance latest 12 months, $bn	Current-account balance % of GDP 2007†	Currency units, per $ Mar 21st	Currency units, per $ year ago	Budget balance % of GDP 2007‡	Interest rates, % 3-month latest	Interest rates, % 10-year gov't bonds, latest
United States	−829.1 Jan	−856.7 Q4	−5.9	–	–	−2.2	5.21	4.54
Japan	+83.9 Jan	+173.3 Jan	+3.8	116	118	−4.9	0.57	1.56
China	+204.8 Feb	+160.8 2005	+7.6	7.74	7.81	−1.7	2.84	3.18
Britain	−154.2 Jan	−69.7 Q3	−3.1	0.52	0.51	−2.5	5.53	4.82
Canada	+47.3 Jan	+21.4 Q4	+0.9	1.18	1.16	1.2	4.17	4.11
Euro area	−9.4 Dec	−20.2 Dec	nil	0.76	0.77	−1.5	3.90	na
Austria	−0.2 Dec	+12.2 Q3	+1.1	0.76	0.77	−1.2	3.90	3.91
Belgium	+17.0 Jan	+6.8 Sep	+2.2	0.76	0.77	0.1	3.95	3.94
France	−36.0 Jan	−32.4 Jan	−1.4	0.76	0.77	−2.5	3.90	3.91
Germany	+209.6 Jan	+152.0 Jan	+4.8	0.76	0.77	−1.4	3.90	3.86
Greece	−44.3 Dec	−30.5 Jan	−7.1†	0.76	0.77	−2.9	3.90	4.14
Italy	−26.3 Jan	−46.9 Jan	−1.9	0.76	0.77	−3.2	3.90	4.11
Netherlands	+42.5 Jan	+59.7 Q4	+7.8	0.76	0.77	0.6	3.90	3.89
Spain	−112.7 Dec	−107.6 Dec	−8.5	0.76	0.77	0.3	3.90	3.92
Czech Republic	+1.9 Jan	−6.1 Q4	−3.3	21.3	20.9	−4.2	2.55	3.76
Denmark	+6.7 Jan	+6.3 Jan	+2.8	5.63	5.70	3.5	4.12	3.88
Hungary	−2.5 Jan	−6.9 Q3	−5.0	190	191	−6.9	7.95	7.01
Norway	+55.4 Feb	+56.1 Q4	+17.5†	6.15	6.24	19.3	4.44	4.44
Poland	−5.6 Jan	−7.7 Jan	−2.5	2.95	2.90	−2.5	4.23	5.17
Russia	+138.0 Jan	+95.6 Q4	+6.0	26.1	26.3	6.1	10.50	6.31
Sweden	+20.0 Jan	+28.4 Q4	+6.1	7.03	6.92	2.9	3.20	3.71
Switzerland	+10.3 Feb	+105.9 Q3	+15.1	1.21	1.22	0.3	2.28	2.62
Turkey	−52.2 Jan	−31.5 Jan	−7.0	1.42	1.42	−2.4	19.13	19.66
Australia	−9.2 Jan	−40.9 Q4	−5.1	1.27	1.28	1.2	6.49	5.79
Hong Kong	−18.9 Jan	+19.3 Q3	+9.4	7.82	7.78	2.0	4.22	4.07
India	−54.6 Jan	−13.7 Q3	−2.3	44.3	44.3	−3.5	7.46	8.27
Indonesia	+39.7 Jan	+7.0 Q3	+1.2	9,220	8,994	−0.9	8.71	6.36§
Malaysia	+29.1 Jan	+22.2 Q3	+12.9	3.51	3.53	−4.3	3.65	5.08§
Pakistan	−13.5 Feb	−6.5 Q4	−5.4†	60.7	60.9	−4.6	10.16	6.78§
Singapore	+34.6 Feb	+36.3 Q4	+23.5	1.53	1.53	0.3	3.00	2.86
South Korea	+17.3 Feb	+5.5 Jan	+0.3	946	930	0.4	4.94	4.86
Taiwan	+13.8 Feb	+25.2 Q4	+5.9	33.0	32.6	−2.2	1.85	2.04
Thailand	+2.2 Dec	+3.2 Dec	+1.9	33.1	36.2	−1.2	4.50	4.15
Argentina	+12.0 Feb	+6.7 Q3	+2.4	3.10	3.07	1.3	9.56	na
Brazil	+45.8 Feb	+14.2 Jan	+0.7	2.11	2.14	−2.2	12.68	6.16§
Chile	+24.4 Feb	+5.2 Q3	+0.8	540	532	4.7	5.04	5.12§
Colombia	−0.1 Dec	−2.3 Q3	−2.3	2,209	2,240	−1.5	7.66	6.07§
Mexico	−8.2 Jan	−1.5 Q4	−1.2	11.2	10.8	−0.6	7.04	7.64
Venezuela	+33.0 Q4	+27.2 Q4	+9.3	3,816	3,343	−3.8	10.09	6.55§
Egypt	−12.6 Q4	+3.0 Q3	+1.3	5.70	5.71	−7.6	8.26	5.33§
Israel	−7.7 Feb	+6.8 Q4	+3.4	4.21	4.22	−2.8	4.33	4.98
Saudi Arabia	+165.7 2006	+90.0 2005	+17.3†	3.75	3.75	12.3	5.09	na
South Africa	−10.2 Jan	−16.3 Q4	−5.9	7.48	7.05	−2.0	9.20	7.63
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*							
Estonia	−3.4 Dec	−2.4 Jan	−13.9†	11.8	11.9	1.5	3.94	na
Finland	+11.6 Jan	+12.8 Jan	+5.6†	0.76	0.77	2.3	3.86	3.93
Iceland	−2.1 Jan	−4.4 Q4	−21.5†	67.3	69.0	0.8	13.63	na
Ireland	+35.5 Dec	−6.5 Q3	−4.4†	0.76	0.77	0.8	3.90	3.91
Latvia	−5.0 Dec	−4.6 Jan	−19.5†	0.54	0.53	−0.5	5.86	na
Lithuania	−5.4 Jan	−3.5 Jan	−10.3†	2.61	2.62	−0.5	4.14	na
Luxembourg	−5.2 Dec	+4.8 Q3	na	0.76	0.77	−0.7	3.90	na
New Zealand	−4.0 Jan	+6.1 Q3	−9.6†	1.45	1.45	3.5	6.75	5.89
Peru	+8.7 Jan	+2.5 Q4	+1.0	3.18	3.19	0.3	4.51	na
Philippines	−4.5 Dec	+4.4 Sep	+3.2	48.7	49.0	−1.0	5.44	na
Portugal	−23.3 Dec	−18.1 Jan	−7.8†	0.76	0.77	−3.7	3.90	4.06
Slovakia	−2.7 Jan	−5.4 Nov	−5.5†	25.7	26.1	−3.0	3.84	4.22
Slovenia	−2.1 Jan	−1.2 Dec	−0.4†	0.76	0.77	−1.2	na	na

*Merchandise trade only. †The Economist poll. ‡Economist Intelligence Unit forecast. §Dollar-denominated bonds.

Sources: National statistics offices and central banks; Thomson Datastream; Reuters; JPMorgan; Bank Leumi le-Israel; Centre for Monitoring Indian Economy; Danske Bank; Hong Kong Monetary Authority; Standard Bank Group; UBS; Westpac.

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About sponsorship

Markets

Mar 22nd 2007
From The Economist print edition

Markets

	Index Mar 21st	% change on one week	% change on Dec 29th 2006 in local currency	% change on Dec 29th 2006 in $ terms
United States (DJIA)	12,447.5	+2.6	–0.1	–0.1
United States (S&P 500)	1,435.0	+3.5	+1.2	+1.2
United States (NAScomp)	2,455.9	+3.5	+1.7	+1.7
Japan (Nikkei 225)	17,163.2	+2.9	–0.4	+0.8
Japan (Topix)	1,708.3	+2.0	+1.6	+2.8
China (SSEA)	3,212.4	+5.2	+14.1	+15.2
China (SSEB, $ terms)	177.6	+4.6	+35.3	+36.5
Britain (FTSE 100)	6,256.8	+4.3	+0.6	+0.7
Canada (S&P TSX)	13,155.6	+2.7	+1.9	+2.4
Euro area (FTSE Euro 100)	1,285.0	+4.4	+0.5	+1.4
Euro area (DJ STOXX 50)	4,078.3	+4.4	–1.0	–0.1
Austria (ATX)	4,540.9	+5.0	+1.7	+2.6
Belgium (Bel 20)	4,382.3	+4.4	–0.1	+0.7
France (CAC 40)	5,502.2	+3.9	–0.7	+0.2
Germany (DAX)*	6,712.1	+4.1	+1.7	+2.7
Greece (Athex Comp)	4,578.2	+4.0	+4.2	+5.1
Italy (S&P/MIB)	40,719.0	+3.6	–1.7	–0.8
Netherlands (AEX)	500.9	+5.8	+1.1	+2.0
Spain (Madrid SE)	1,588.7	+5.2	+2.2	+3.1
Czech Republic (PX)	1,681.4	+3.3	+5.8	+5.1
Denmark (OMXCB)	438.6	+3.4	+3.4	+4.4
Hungary (BUX)	23,062.2	nil	–7.2	–4.9
Norway (OSEAX)	514.8	+4.7	+2.5	+3.6
Poland (WIG)	55,234.9	+4.5	+9.6	+9.3
Russia (RTS, $ terms)	1,847.3	+3.8	–4.9	–3.9
Sweden (Aff.Gen)	381.9	+5.5	+4.5	+2.4
Switzerland (SMI)	8,942.2	+4.2	+1.8	+2.2
Turkey (ISE)	42,419.4	+4.7	+8.4	+10.2
Australia (All Ord.)	5,846.3	+2.1	+3.6	+6.2
Hong Kong (Hang Seng)	19,516.4	+3.6	–2.2	–2.7
India (BSE)	12,945.9	+3.3	–6.1	–4.5
Indonesia (JSX)	1,779.2	+1.0	–1.5	–3.0
Malaysia (KLSE)	1,209.3	+3.7	+10.3	+12.0
Pakistan (KSE)	11,296.6	+0.1	+12.5	+12.9
Singapore (STI)	3,155.7	+3.4	+5.7	+6.5
South Korea (KOSPI)	1,442.9	+2.5	+0.6	–0.3
Taiwan (TWI)	7,757.0	+2.5	–0.9	–2.4
Thailand (SET)	669.6	–0.2	–1.5	+11.3
Argentina (MERV)	2,083.6	+3.6	–0.3	–1.4
Brazil (BVSP)	45,630.0	+5.4	+2.6	+5.7
Chile (IGPA)	13,480.0	+3.2	+8.9	+8.2
Colombia (IGBC)	10,921.5	+7.1	–2.1	+0.9
Mexico (IPC)	28,219.6	+5.6	+6.7	+4.3
Venezuela (IBC)	48,861.5	–2.9	–6.5	–10.6
Egypt (Hermes)	62,579.3	–0.1	+2.1	+2.2
Israel (TA-100)	962.4	+0.2	+4.4	+5.1
Saudi Arabia (Tadawul)	8,560.8	–0.5	+7.1	+7.1
South Africa (JSE AS)	26,360.9	+4.4	+5.8	+1.5
Europe (FTSEurofirst 300)	1,492.6	+4.6	+0.6	+1.5
World, dev'd (MSCI)	1,512.2	+3.8	+1.9	+1.9
Emerging markets (MSCI)	909.2	+4.2	–0.4	–0.4
World, all (MSCI)	374.2	+3.9	+1.7	+1.7
World bonds (Citigroup)	669.7	–0.1	+1.7	+1.7
EMBI+ (JPMorgan)	416.8	+0.6	+2.3	+2.3
Hedge funds (HFRX)	1,290.6	+0.9	+1.2	+1.2
Volatility, US (VIX)	12.2	17.3	11.6	(levels)
CDSs, Eur (iTRAXX)†	22.0	+3.5	+2.9	+3.8
CDSs, N Am (CDX)†	31.6	+0.2	+7.7	+7.7
Carbon trading (EU ETS) €	0.87	–21.6	–86.2	–86.1

*Total return index. †Credit-default swap spreads, basis points.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; JPMorgan Chase; Bank Leumi le-Israel; CBOE; CME; Danske Bank; EEX; HKMA; Markit; Standard Bank

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Metals

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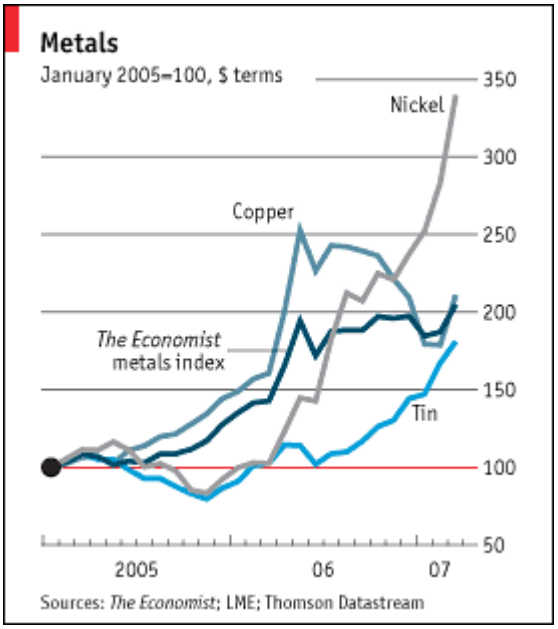

The Economist metals index hit a new high this week, as shortages and strong demand continued to support prices. Nickel has risen by 44% this year, with the cash price briefly breaching $50,000 a tonne; stocks in London Metal Exchange warehouses are below one day's global consumption. Tin prices have passed $14,000 a tonne for the first time in more than 20 years. Supplies from Indonesia, the biggest exporter, have been disrupted following the government's crackdown on illegal mining. Indonesia's output is forecast to fall sharply this year. Copper prices are rising again, thanks to continuing strong demand from China. However, aluminium prices are only 13% higher than they were a year ago.

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